BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of Department of Enforcement, Complainant, vs. Patrick Orvil Nugent Sunnyvale, CA, Respondent.	DECISION Complaint No. C01040010 Dated: February 23, 2006

Respondent participated in private securities transactions without prior written notice to, and approval of, his member firm. Held, Hearing Panel's findings and sanction affirmed.

APPEARANCES

For the Complainant: Mark Graves, Esq., Leo F. Orenstein, Esq., Department of Enforcement, NASD

For the Respondent: Pro Se

DECISION

Patrick Orvil Nugent ("Nugent") appeals this matter pursuant to NASD Procedural Rule 9311. The Hearing Panel found that Nugent violated NASD Conduct Rules 3040 and 2110 by participating in the offer and sale of promissory notes, for compensation, to 25 customers without prior written notice to, and written approval of, his employer. The Hearing Panel barred Nugent in all capacities. After a complete review of the record, we affirm the Hearing Panel's findings of violations and the imposed sanction.

I. Background

A. Nugent's Employment History

Nugent first associated with a member firm in 1989 as an investment company products and variable contracts limited representative and principal. Nugent began working for Multi-Financial Securities Corporation ("MFSC") in 1993 as a general securities representative, general securities principal, and investment company products and variable contracts limited principal. MFSC terminated Nugent's employment in August 2002 for selling unapproved promissory notes away from the firm. Nugent was last associated with a member firm in January 2005.

B. Procedural History

The Department of Enforcement ("Enforcement") filed a two-cause complaint against Nugent on May 7, 2004. The complaint alleged that Nugent participated, for compensation, in the sale of promissory notes that were private securities transactions without providing prior notice to, and receiving approval from, his employing member firm, in violation of Conduct Rules 3040 and 2110. In the alternative, the complaint alleged that Nugent engaged in outside business activities by participating in the sale of promissory notes, without giving prompt written notice to his firm, in violation of Conduct Rules 3030 and 2110.[1]

The Hearing Panel held a one-day hearing on November 8, 2004. On January 6, 2005, the Hearing Panel issued its decision in which it found that Nugent engaged in private securities transactions without providing notice to his firm as alleged in the complaint. This appeal followed.

II. Facts

The marketing directors for Life USA, a life insurance company in Salt Lake City, Utah, introduced Nugent to a secured commercial note program ("Wynn notes") offered by the Wynn Company ("Wynn"). Wynn was a Utah corporation engaged in the sale of used automobiles through high interest loans to customers with impaired credit ratings. The automobile loans carried an annual interest rate of 24-30 percent and an average term of 24 months. Wynn used the funds raised through selling the Wynn notes to finance its operations.[2]

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1 Conduct subject to the requirements of Rule 3040 is exempted from the requirements of Rule 3030. Conduct Rule 3030.

2 Wynn stated in its promotional materials that its purpose in issuing the notes was to "enlarge [its] customer base in the automobile sales industry [by] aggressively seeking and securing private capital to expand the growing business."

According to the Wynn promotional materials, the Wynn notes bore a nine-month maturity date and provided an interest rate of nine percent. At maturity, the investor could liquidate the note, repurchase it, or invest an additional amount. If an investor repurchased a note, or invested an additional amount after maturity, the note provided a 10 percent interest rate. Several of the Wynn notes that Wynn initially issued to Nugent's customers, however, actually bore a 12-month maturity date with an interest rate of 10 to 11 percent.

An investor received from Wynn a promissory note and an "Assignment of Payments Agreement." Wynn pledged in the Assignment of Payments Agreement to secure the Wynn notes through income generated by the automobile loan contracts and the titles to the vehicles. The Wynn promotional material stated that an independent escrow agent monitored the notes to ensure that collateral was maintained at 130 percent of each note's value.

Nugent testified that he conducted three self-described "audits" at the offices of the Wynn escrow agents between March and July 2000.[3] Nugent stated that during these audits he reviewed the files of several Wynn note purchasers and that these files included, among other items, the customer applications for the purchase of the Wynn notes, the Wynn notes themselves, and the titles to the automobiles. Based on his review of the sampling of customer files, Nugent believed that "everything was in order." Nugent, however, did not verify whether an automobile existed for each title or that one title was used to collateralize only one note. At the hearing below, Nugent testified that he now believes that the Wynn notes were not collateralized as represented and that the vehicle titles must have been used as collateral for multiple notes.

Nugent referred 25 MFSC customers to the Wynn note program between December 1999 and February 2002. These customers initially purchased $1,498,504.41 worth of Wynn notes. Several of these customers repurchased the notes upon maturity. Nugent represented that the amount reinvested totaled $696,000. NASD staff, however, compiled data related to Nugent's Wynn note transactions that reflects that approximately $1.6 million was reinvested. Wynn paid Nugent $61,936.45 in finder's fees for the initial note purchases. Nugent represented that Wynn owes him an additional $54,054.09 in finder's fees related to the reinvestment transactions. Wynn, however, filed for bankruptcy and has not paid Nugent any of the $54,054.09 purportedly due to him. As a result, Nugent is an unsecured creditor in the Wynn bankruptcy proceedings.

By September 2000, Nugent was on notice that Wynn's financial condition was tenuous. Wynn had ceased paying Nugent finder's fees on reinvestment transactions. Nugent, however, failed to inform his customers of Wynn's financial deterioration. Instead, Nugent continued to refer customers to the Wynn note program and took no action to discourage customers from reinvesting in the notes upon maturity. One of Nugent's customers, JS, testified that in July 2001, JS questioned Nugent about Wynn's financial stability in advance of reinvesting in the Wynn notes. Nugent assured JS that he had recently visited Wynn in Utah and "everything

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[3] A CPA firm was the original escrow agent. A law firm subsequently became the escrow agent.

[was] fine." JS subsequently repurchased a Wynn note. In his hearing testimony, Nugent stated, "I'm not real sure, that what I told [JS] was the truth."

III. Discussion

Conduct Rule 3040 prohibits an associated person from participating in private securities transactions for compensation without first providing written notice to, and receiving written approval from, his employer firm. Conduct Rule 3040 applies to a securities transaction "outside the regular course or scope of an associated person's employment with a member." Conduct Rule 3040(e)(1). Before the NAC, Nugent does not dispute that the Wynn notes were securities.[4] For the reasons set forth in detail below, we agree with the Hearing Panel's finding that the Wynn notes were securities.

The Supreme Court devised the "family resemblance" test in *Reves v. Ernst & Young*, 494 U.S. 56, 62-63 (1990), for determining whether a particular note is a "security" for purposes of federal securities laws and regulations. Under the family resemblance test, all promissory notes are presumed to be securities, and this presumption is rebutted only by a showing that the investments bear a strong resemblance to a list of financial instruments specifically excluded as securities by the Supreme Court in *Reves*, or by proving, under a four-factor test, that the note is of a type that should be added to the list of excluded financial instruments. *Id.* at 66; *see also Stoiber v. SEC*, 161 F.3d 745, 749 n.7 (D.C. Cir. 1998) (articulating that the "mere introduction of some evidence suggesting that [the] note[s]" are not securities is not enough to overcome this presumption).

The four factors considered in *Reves* do not suggest that the Wynn notes should be added to the list of excluded financial instruments.[5] Wynn sold the notes to raise money to conduct its

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[4] Nugent argued before the Hearing Panel that he did not notify MFSC of his participation in the Wynn note transactions because he concluded that the notes were not securities. In reaching that conclusion, Nugent relied upon an opinion of counsel letter written by the law firm that served as an escrow agent for the purported collateral backing the Wynn notes. It is insufficient, however, for a registered representative to rely on bare representations by an issuer or its representative in determining whether an instrument is a security. *Gilbert M. Hair*, 51 S.E.C. 374, 377 (1993). In this case, Nugent's reliance was highly unreasonable because the opinion letter expressly stated that the opinion "shall not be relied upon by any party other than [Wynn] . . . and has no efficacy to any other party."

[5] The four factors considered in *Reves* for whether a note should be added to the list of statutorily exempt notes are: (1) the motivations that would prompt a reasonable borrower and lender to enter into the transaction; (2) the plan of distributing the notes; (3) the reasonable expectations of the investing public regarding whether the instruments were securities; and (4) the presence of any alternative scheme of regulation or other factor that significantly reduces the

[Footnote continued on next page]

purported regular business, which was the purchase and resale of automobile installment loan contracts. *See Reves*, 494 U.S. at 66 (explaining that an instrument is likely a security when the seller's purpose is to raise operational capital). In addition, the Wynn notes were distributed broadly. Nugent stated that he sold the notes to 25 investors. *See Stoiber*, 161 F.3d at 750; *Robin Bruce McNabb*, 54 S.E.C. 917, 924 n.24 (2000) (*citing Trust Co. v. N.N.P., Inc.*, 104 F.3d 1478, 1489 (5th Cir. 1997) ("A debt instrument may be distributed to but one investor, yet still be a security.")), *aff'd*, 298 F.3d 1126 (9th Cir. 2002). The public's reasonable perceptions of the Wynn notes also suggest that we categorize the notes as securities. *See Stoiber*, 161 F.3d at 751 (*citing Reves*, 494 U.S. at 68-69). A reasonable investor giving funds to receive a guaranteed rate of return ranging from 9 to 11 percent would consider that the notes were an investment. Finally, we conclude that there is no regulatory scheme providing an adequate substitute for the protection of the federal securities laws applicable to these instruments. *See Reves*, 494 U.S. at 72.

A note may still be excluded from the coverage of the federal securities laws and regulations if it is of a certain type and "has a maturity at the time of issuance not exceeding nine months." 15 U.S.C. § 77c(a)(3) (2000); 15 U.S.C. §78c(a)(10) (2000). Although some of the Wynn notes had a purported maturity period of nine months, we do not find that they should be excluded from the definition of "security" under the short-term note exception. The exception "was meant to apply to 'short term paper of the type available for discount at a Federal Reserve bank and of a type which rarely is bought by private investors.'" *See SEC v. R.G. Reynolds Enters., Inc.*, 952 F.2d 1125, 1132 (9th Cir. 1991) (*quoting* H.R. Rep. No. 85-15 (1933)); *see also Holloway v. Peat, Marwick, Mitchell & Co.*, 900 F.2d 1485, 1489 (10th Cir. 1990) ("[The] exception for short-term notes is limited to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public."). The Wynn notes were not of this class; we thus conclude that the Wynn notes were securities.[6]

We also agree with the Hearing Panel's finding that Nugent violated Conduct Rule 3040.[7] Conduct Rule 3040 requires an associated person to provide his employer with written notice of

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risk of the instrument so as to make regulation under the securities laws unnecessary. *Reves*, 494 U.S. at 66-67.

[6] The Commission previously found that a similar promissory note program involved the sale of securities. *See Chris Dinh Hartley*, Exchange Act Rel. No. 50031, 2004 SEC LEXIS 1507, at *7-8 (July 16, 2004) (finding promissory notes were securities when notes paid 10 percent interest and were offered to the public for the purpose of financing the purchase of automobile installment loan contracts).

[7] Even if we determined that the Wynn notes were not securities, we would conclude that Nugent engaged in violative conduct. Enforcement alternatively alleged that Nugent violated Conduct Rule 3030 by engaging in unapproved outside business activities. Conduct Rule 3030

[Footnote continued on next page]

private securities transactions before the transactions take place. *See* Conduct Rule 3040(b). The Commission has held that the written notice must describe in detail the proposed transactions, the associated person's proposed role in the transactions, and state whether the associated person has received or may receive selling compensation in connection with the transactions. *Anthony H. Barkate*, Exchange Act Rel. No. 49542, 2004 SEC LEXIS 806, at *2 (Apr. 8, 2004), *aff'd*, 125 Fed. Appx. 892 (9th Cir. 2005). If the associated person is compensated for the transactions, he must receive the firm's written permission before he engages in these transactions. *See* NASD Conduct Rule 3040(c). A finder's fee falls within the definition of selling compensation. NASD Conduct Rule 3040(e)(2).

Nugent admits that he received $61,936 in finder's fees from Wynn for referring customers to the Wynn note program. Nugent further admits that he provided no written notice to, and received no written approval from, MFSC prior to engaging in the Wynn note transactions. Moreover, the Wynn notes were unapproved products, and MFSC prohibited the sale of all promissory notes. In September 1998, Nugent completed an annual compliance statement as part of his ongoing employment with MFSC. The compliance statement provided that MFSC associated persons could not "sell products not currently approved by MFSC; solicit or sell any product away from MFSC, *whether or not the product is considered to be a security*, without the prior written consent of MFSC; [or] raise money or participate in the raising of money for any company, individual or venture without the written consent of MFSC." In May 2001, Nugent attended an MFSC sales and compliance meeting where MFSC warned of the dangers of promissory notes and identified them as an unapproved product. The presentation also made clear that a representative had to seek pre-approval from MFSC's compliance department before engaging in any outside business activities. Despite these warnings and prohibitions, Nugent gave MFSC no notice of his Wynn activities. Nugent's sale of the Wynn notes constituted private securities transactions in violation of Conduct Rules 3040 and 2110.[8]

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prohibits any person associated with a member firm from being "employed by, or accept[ing] compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member." It is undisputed that Nugent failed to notify MFSC, in any capacity, of his activities with Wynn and that he received compensation for his participation in the Wynn note transactions. Thus, under the alternative theory alleged in the complaint, we would find that Nugent violated Conduct Rules 3030 and 2110.

[8] A violation of Conduct Rule 3040 also constitutes a violation of Conduct Rule 2110. *Stephen J. Gluckman*, 54 S.E.C. 175, 185 (1999). NASD Rule 115 extends NASD rule requirements to persons associated with a member.

IV. Sanctions

The Hearing Panel barred Nugent from associating with any member for engaging in private securities transactions. We affirm the Hearing Panel's imposition of the bar.

The NASD Sanction Guidelines ("Guidelines") for private securities transactions provide that an adjudicator's first step in determining sanctions is to assess the quantitative extent of the transactions.[9] The Guidelines provide for a fine between $5,000 and $50,000 and the imposition of a suspension of one year to a bar when the dollar amount of the sales exceeds $1 million.[10] Nugent sold more than $1.4 million in Wynn notes to 25 customers over a two-year period.[11] This is an egregious case, and the quantitative factors present here support the imposition of a bar.

The Guidelines also state that "[t]he presence of one or more mitigating or aggravating factors may either raise or lower the sanctions."[12] The Guidelines therefore direct that we consider 10 additional principal considerations and the general principles applicable to all violations in determining the appropriate sanction.[13] Several of these factors are relevant and serve to aggravate Nugent's misconduct.

First, the sale of the Wynn notes resulted in Nugent's monetary gain.[14] He testified that he received over $61,000 in finder's fees from Wynn. Second, Nugent's private securities transactions involved MFSC's customers.[15] Third, Nugent's misconduct exposed these customers to substantial harm.[16] Any customers that had not cashed out before Wynn filed for bankruptcy are likely unsecured creditors in the bankruptcy proceedings. Finally, Nugent

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9 *See NASD Notice to Members 03-65* (NASD Revises NASD Sanction Guidelines).

10 *Id.*

11 We have not relied on the amounts reinvested in the Wynn notes in determining the appropriate sanction.

12 *NASD Notice to Members 03-65*.

13 *Id.*

14 Guidelines (2001 ed.) at 10 (Principal Considerations in Determining Sanctions) (misconduct resulting in the potential for respondent's monetary gain is an aggravating factor under the Guidelines).

15 *NASD Notice to Members 03-65*

16 *Id.*

continued to engage in the selling away activity even after he attended an MFSC compliance meeting in which MFSC made clear that promissory notes were unapproved products and that all outside business activities had to be pre-approved by the MFSC compliance department.[17]

Nugent seeks a reduction in sanctions based upon a newly acquired "understanding of [his] responsibilities and duties" as a registered person. As a registered person, Nugent is "assumed as a matter of law to have read and have knowledge of [NASD's] rules and requirements." *See Carter v. SEC*, 726 F.2d 472, 474 (9th Cir. 1983). Furthermore, we conclude that Nugent's conduct was egregious and that no reduction of sanctions is warranted. In this respect, we find highly aggravating that Nugent was aware that Wynn was experiencing financial difficulties yet continued to refer customers to the Wynn note program and told existing customers that Wynn's financial condition was "fine."[18]

Accordingly, we bar Nugent for his violations of Conduct Rules 3040 and 2110.[19]

V. Conclusion

We affirm the Hearing Panel's finding that Nugent engaged in private securities transactions without prior written notice to, and written approval from, his employer. Accordingly, we impose a bar in all capacities. We affirm the Hearing Panel's imposition of hearing costs against Nugent of $1,754.50. The bar will be effective immediately upon service of this decision.[20]

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney, Senior Vice President
and Corporate Secretary

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[17] *Id.*

[18] Guidelines at 9 (misleading a customer or lulling a customer into inactivity is an aggravating factor under the Guidelines).

[19] Enforcement sought an order requiring Nugent to pay restitution to his customers. We determine that an order of restitution would be inappropriate here because the record is unclear regarding the customers' quantifiable loss. *See* Guidelines at 6-7 (General Principles Applicable To All Sanction Determinations).

[20] We also have considered and reject without discussion all other arguments of the parties.