NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

MAGELLAN SECURITIES, INC.
(CRD No. 15986),

Harper Woods, MI ,

and

TERRY M. LAYMON
(CRD No. 304342),

Grosse Point Woods, MI,

Respondents.

Disciplinary Proceeding
No. C3B010016

Hearing Officer—Andrew H. Perkins

HEARING PANEL DECISION

December 30, 2002

Respondents violated NASD Conduct Rules 2110 and 3010 by failing to exercise reasonable supervision. Laymon and the firm are censured and jointly and severally fined $20,000; Laymon also is barred as a supervisor and suspended for two years from associating with any member firm in any principal capacity. Laymon is required to requalify by examination before he resumes any responsibilities as a General Securities Principal.

Appearances

For the Department of Enforcement: David Utevsky, NASD, Seattle, Washington; Rory C. Flynn, NASD Chief Litigation Counsel, Washington, DC, Of Counsel.

For Magellan Securities, Inc. and Terry M. Laymon: Gary M. Saretsky, HERTZ, SCHRAM & SARETSKY, Bloomfield Hills, Michigan.

DECISION

I. INTRODUCTION

The Department of Enforcement ("Department") charged Magellan Securities, Inc. ("Magellan" or the "Firm") and its President, Terry M. Laymon ("Laymon"), with violating NASD Conduct Rules 2110 and 3010 by failing to supervise Dennis L. Dunn ("Dunn"), a registered General Securities Representative formerly associated with the Firm. The Respondents filed an Answer denying the charge and requesting a hearing, which was held in Troy, Michigan, on October 16, 2002, before a Hearing Panel composed of the Hearing Officer and two members of the District 8 Committee.[1] The hearing was limited to the issue of sanctions because, at the Final Pre-Hearing Conference on October 10, 2002, the Respondents stipulated to the issue of liability.[2]

II. FINDINGS OF FACT

A. The Respondents

Magellan, an NASD member since February 20, 1985, conducts a general securities business.[3] The Firm has 12 offices in nine states with 22 registered representatives.[4] Magellan's principal place of business is located in Harper Woods, Michigan. Laymon is the Firm's President, and he solely is responsible for supervising all of the Firm's registered representatives.[5] Laymon

[1] References to the hearing transcript are cited as "Tr. __"; references to the Department's exhibits are cited as "CX–." The Respondents did not offer any exhibits.

[2] At the beginning of the hearing, the Parties submitted a written Agreed Stipulation of Facts ("Stip.").

[3] Stip. ¶ 1.

[4] *Id.* ¶ 2.

[5] *Id.* ¶¶ 3, 6.

has been registered as a General Securities Representative and a General Securities Principal through Magellan since September 6, 1988.[6]

B. Background

The charges against the Respondents arose from Dunn's misconduct in the sale of securities issued by First Fidelity Acceptance Corp. ("FFAC"). FFAC was a Nevada corporation with its principal place of business in Plano, TX.[7] FFAC issued stock that traded on the NASDAQ Bulletin Board under the stock symbol "FFAC." At all times relevant to this proceeding, the stock was trading at less than one dollar per share.[8]

FFAC's purported business was the purchase of automobile retail installment sales contracts ("Auto loans") made by borrowers with substandard credit.[9] FFAC represented that it had an arrangement to pool the Auto loans and then sell the resulting loan pools to Dain Bosworth without recourse.[10] Interests in the loan pools, evidenced by Trust Certificates, were sold to individual investors. The FFAC Trust Certificates bore interest at 3¼ % plus the prime rate of interest.[11] Thus, at the time, the Trust Certificates were expected to return approximately

[6] *Id.* ¶ 3.

[7] C–37, at 3.

[8] Tr. 38.

[9] *Id*. at 29–30.

[10] *Id.* at 30. Dain Bosworth Incorporated was a broker-dealer in Minneapolis, MN.

[11] Tr. 13.

11¼ %.[12] FFAC, however, actually operated as a Ponzi scheme.[13] Ultimately, FFAC collapsed, costing investors millions in losses.[14]

In 1997, Dunn was a practicing attorney in Salem, Oregon, with a focus on estate planning. In connection with his law practice, Dunn sold securities to his estate planning clients. Dunn testified at the hearing that when he completed clients' estate plans, he would suggest that he also could help them with their investments.[15] Dunn explained that he preferred to offer his clients a mix of mutual funds, fixed annuities, and what he called "niche products" rather than stock.[16] Dunn used the term "niche products" to refer to a variety of higher risk investments such as secondary limited partnership interests.[17] The common denominator among these preferred offerings seemed to be a higher commission payout to him than what he could expect to receive selling stock.

One such niche product that caught Dunn's interest was FFAC Trust Certificates. Dunn began selling these to his clients after he associated with United Pacific Securities, Inc. in August 1996.[18] Dunn considered this a "nifty little product" because it had a high rate of return, no commissions charged to the investor, and a 5% commission to the selling agent.[19] Indeed, Dunn became so enamored with FFAC that he started selling his clients stock in the company in addition

[12] *Id.* at 16.

[13] *Id.* at 78.

[14] *Id.* at 33. Investors who purchased FFAC Trust Certificate Notes and FFAC stock from Dunn lost as much as $2 million.

[15] Tr. 19.

[16] *Id.* at 16.

[17] *Id.*

[18] Tr. 13–14.

[19] *Id.*

to the FFAC Trust Certificates. After studying FFAC's business, Dunn concluded that purchasing the FFAC stock represented a "lifetime opportunity" to get rich.[20] Dunn projected that FFAC stock would rise from 20 cents to about $2.50 per share.[21]

In January 1997, Dunn left United Pacific and joined Magellan because United Pacific had become uneasy with the volume of FFAC Trust Certificates Dunn was selling.[22] Dunn estimated that 80% of his securities business involved FFAC.[23] Before joining Magellan, Dunn told Laymon about the nature of his practice and asked if he could do secondary market transactions. Laymon approved Dunn's business plan and, without meeting him, signed Dunn on as an independent agent.[24] Laymon did not meet Dunn until August 1997 when he attended a Firm compliance meeting in Michigan.[25]

With Magellan, Dunn continued to sell FFAC stock and FFAC Trust Certificates to his law firm clients. But he soon became disgruntled with the fees Magellan's clearing firm charged on the stock transfers.[26] He therefore decided to implement a system that would avoid those charges. Dunn proposed to Laymon that Dunn be permitted to purchase FFAC stock for Magellan customers from J. Alexander Securities,[27] rather than Magellan's clearing broker-

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[20] *Id.* at 32–33.

[21] *Id.* at 35.

[22] *Id.* at 17–18.

[23] Tr. 18.

[24] Dunn's status as an independent contractor is set out in the Agency Agreement between him and Magellan dated August 15, 1997. (CX–6.)

[25] Tr. 194.

[26] Stip. ¶ 10.

[27] With Laymon's approval, Dunn opened an account at J. Alexander in May 1997. (Tr. 62–63.) Before that, Dunn maintained an account at Toluca Securities, which Laymon also approved. (Tr. 61–62, 42.)

dealer.[28] Under this arrangement, Dunn could charge customers 5% more than the current "asked" price, which would enable him to receive more compensation for the trades than he would have received if he obtained the stock through Magellan's clearing broker-dealer.[29] Dunn testified that he told Laymon about his plan to charge a 5% markup and that Laymon did not question how Dunn planned to handle the proceeds for these sales.[30] For his part, Laymon testified that Dunn probably told him about the plan, but he "probably didn't listen."[31] In any event, Laymon admits that he did not object to the plan, advising only that NASD's markup policy would apply.[32]

In some instances, Dunn sold customers FFAC stock from his own "inventory" in his personal securities account [33] In these instances, Dunn determined the sales price by calling a market maker at J. Alexander to get the current "asked" price. Dunn then added 5% to the quote and sold the stock at that price.[34] Dunn did not base the sales price on his cost of acquiring the stock. Thus, Dunn obtained the benefit of the spread between the "bid" and "asked" price as well as the 5% markup, as if he were a broker-dealer making a market in FFAC stock.[35]

In other transactions, after receiving customer orders, Dunn purchased a block of FFAC stock in his own name with a view to reselling the shares to his clients. As he sold the stock, Dunn would instruct FFAC's transfer agent to issue stock certificates in the purchasers' names and to

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[28] Stip. ¶ 11.

[29] *Id.*

[30] Tr. 46–47; Stip. ¶ 20.

[31] Tr. 138.

[32] Stip. ¶ 11; Tr. 44.

[33] Tr. 69; Stip. ¶ 13.

[34] Tr. 71; Stip. ¶ 13.

[35] Stip. ¶ 13.

issue a new certificate to himself for the balance of shares.[36] Dunn purchased the stock at, or slightly below, the "asked" price; he then added 5% to that price when he resold the stock.[37]

Laymon approved of the documentation for the foregoing transactions. Specifically, Laymon approved the form of the letter agreement Dunn had each customer sign, which disclosed the Dunn charged them 5% more than the "asked" price.[38] All of the letter agreements were on Magellan stationery.

Dunn also sent Laymon copies of the completed letter agreements with the intention that Laymon would sign each letter to confirm Magellan's approval of the transaction.[39] Laymon did not sign the letters; instead, the staff at Magellan's office filed each letter without Laymon's signature.[40]

Although the foregoing transactions were not processed through Magellan's clearing firm, and the stock was not held in the customers' accounts at Magellan, Dunn prepared order tickets on Magellan's forms for each of the transactions. Dunn sent these tickets to Magellan's main office where they were available for Laymon's review. However, Laymon did not review the order tickets.[41]

Between February 1997 and December 1997, Dunn sold 993,055 shares of FFAC stock to 31 of Magellan's customers at a total purchase price of $298,330. None of these transactions

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[36] Tr. 44–46; Stip. ¶ 18.

[37] Stip. ¶ 14.

[38] Stip. ¶ 15; *Cf.* Tr. 21 (Dunn testified that, on occasion, he sent Laymon a copy of the form letter agreement for his review.) An example of the letter agreement is found at Exhibit CX–12D, at page 5.

[39] Each of the letter agreements shows that Laymon was sent a copy, but none contained a signature line for Laymon.

[40] Stip. ¶ 16; Tr. 44–45.

[41] Stip. ¶ 17.

cleared through Magellan's clearing broker-dealer or appeared on Magellan's books and records.[42] The customers paid Dunn directly, and he deposited the payments in his law office operating account.[43]

C. Supervision

In 1997, Magellan and Laymon failed to exercise reasonable supervision of Dunn's activities as follows:

(1) The Respondents failed to conduct an on-site compliance examination of Dunn's office.

(2) The Respondents failed to review correspondence generated and received at Dunn's office.

(3) The Respondents failed to review the customer account documentation Dunn sent to Laymon.

(4) The Respondents failed to review Dunn's trading activity in his securities account at J. Alexander.

Moreover, Laymon made the conscious election to permit Dunn to run his own office without adequate supervision. Laymon's failures were not just the result of poor execution of his supervisory responsibilities or of inadequate firm policies and procedures. Laymon chose not to supervise Dunn.

The Hearing Panel's conclusions are supported by Laymon's own testimony. Laymon admitted at the hearing that he believed that Dunn required less supervision than other registered

[42] Stip. ¶ 12.

[43] Tr. 55; Stip. ¶ 19. Dunn testified that he kept an electronic blotter of all transactions. (Tr. 69.)

representatives did because he was a licensed attorney.[44] Thus, for instance, Laymon concluded that he did not need to review Dunn's correspondence.[45] Laymon thought that Dunn would know what he could include in his correspondence with customers because he was an attorney.[46] Likewise, Laymon concluded that he did not need to review Dunn's files because Dunn told him that he had "great files"[47] and Laymon "knew the way attorneys keep files."[48] In other words, Laymon completely abdicated his supervisory responsibilities.

Laymon also authorized Dunn to sell FFAC stock from his own account at J. Alexander, without any review of those transactions. Laymon failed to follow up to determine how Dunn was handling his clients' funds, and he failed to review any of Dunn's account records that J. Alexander sent to Magellan at Laymon's request.[49] These were grievous violations of Laymon's responsibilities as a registered principal and a supervisor, which directly led to Dunn's violations. The net effect of the Respondents' supervisory defaults was to allow Dunn to effect securities transactions without being registered as a broker-dealer, in violation of Section 15(a)(1) of the Securities Exchange Act of 1934[50] and NASD Conduct Rule 2110.[51]

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[44] Tr. 176.

[45] Tr. 177.

[46] *Id.*

[47] CX–14, at 1.

[48] Tr. 123.

[49] In the letter granting Dunn permission to maintain a securities account at J. Alexander, Laymon requested J. Alexander to send Magellan copies of documents related to Dunn's trades. (CX–15.)

[50] 15 U.S.C. § 78o(a)(1).

[51] Dunn entered into a Letter of Acceptance, Waiver and Consent in which he consented to findings by NASD that he violated Section 15(a)(1) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o(a)(1), and NASD Conduct Rule 2110. (CX–33.)

III. CONCLUSIONS OF LAW

NASD Conduct Rule 3010 requires that NASD members "establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably[52] designed to achieve compliance with applicable securities laws and regulations, and with the Rules of [NASD]. Final responsibility for proper supervision shall rest with the member." The member's system must include "procedures to supervise the types of business in which it engages."[53] Ultimately, the duty to supervise is a firm's obligation although it is performed on a daily basis by individuals. Thus, the burden falls to a firm to implement effective procedures, staffing, and to provide sufficient resources and a system of follow-up and review to determine that any responsibility to supervise is being diligently exercised.[54]

The supervisory responsibilities of firms that employ widespread networks of independent contractors are no different from the responsibilities of more traditionally structured firms. The Commission has emphasized that it "does not recognize the concept of independent contractors for purposes of the Exchange Act."[55] Similarly, NASD does not distinguish between the supervision of representatives who are employees and those who are independent contractors.[56]

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[52] The standard of reasonableness is determined based on the particular circumstances of each case. *See District Bus. Conduct Comm. v. William A. Lobb*, No. C07960105, 2000 NASD Discip. LEXIS 11, at *16 (NAC Apr. 6, 2000) (citations omitted).

[53] Rule 3010(b)(1).

[54] *Patricia Bellow*s, SEC Initial Dec. Release No. 128, SEC Docket 1426, 1998 SEC LEXIS 1521, at *22 (July 23, 1998), *affirmed* Exchange Act Release No. 40411, 67 SEC Docket 2091, 1998 SEC LEXIS 1892 (Sept. 8, 1998).

[55] *William V. Giordan*o, Exchange Act Release No. 36742 (Jan. 19, 1996); *see also VESTAX Sec. Corp. v. Skillman*, 117 F. Supp. 2d 654 (N.D. Ohio 2000); *In re Seco Sec., Inc*, Exchange Act Release No. 26054 (Sept. 1, 1988).

[56] *See John Titu*s, 52 S.E.C. 1154, 1996 SEC LEXIS 3341 (Dec. 9, 1996) (observing that NASD Rule 3010 requires that "all associated persons located at 'non-branch' locations must be subject to the same level of compliance supervision as associated persons located in a branch office or the member's main office."); *see also*

Indeed, firms that operate remote branch locations face greater supervisory challenges "to meet the same high standards of supervision as at more traditionally organized firms."[57] Of particular note for this case, the Commission has indicated that firms must perform on-site audits of remote locations and not rely on compliance checklists in order to meet their supervisory obligations.[58] Moreover, firms must establish and implement effective procedures to ensure that a qualified supervisor reviews correspondence generated and received by remote locations.[59]

Here, the evidence demonstrates a complete failure to supervise Dunn. Laymon concluded that he could get away with not supervising Dunn because he also was a practicing attorney. In essence, Laymon permitted Dunn to operate as a broker-dealer, without any meaningful review and supervision. In so doing, Laymon demonstrated a total disregard for the protection of Magellan's customers.

IV. SANCTIONS

The Department requested that Magellan be censured and fined $20,000 and that Laymon be barred as a supervisor, be suspended for two years as a principal, be fined $20,000, and be required to re-qualify as a principal.[60] The Hearing Panel agrees with the Department's assessment

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NASD Notice To Members 86-65 "Compliance with the NASD Rule of Fair Practice in the Employment and Supervision of Off-Site Personnel," (Sept. 12, 1986).

[57] *Royal Alliance Assoc., Inc*., Exchange Act Release No. 38174, 1997 SEC LEXIS 113, at *15-16 (Jan. 15, 1997).

[58] *Cf. Stuart, Coleman & Co.*, Exchange Act Release No. 38001, 1996 SEC LEXIS 3266, at *9–10 (Dec. 2, 1996) (finding that the firm failed to conduct unannounced branch office inspections, using inspection criteria during on-site visits designed to detect and prevent securities law violations).

[59] *Conrad C. Lysia*k, Exchange Act Release No. 33245 (Nov. 24, 1993), *aff'd*, 47 F.3d 1175 (9th Cir. 1995).

[60] The Department's request is within the range of sanctions recommended by the NASD Sanction Guidelines for failure to supervise. The Sanction Guidelines recommend a fine of between $5,000 and $50,000, and, in egregious cases, consideration of a suspension or a bar. *See* NASD Sanction Guidelines 108 (2001 ed.).

that this is an egregious case, warranting serious sanctions. Accordingly, the Hearing Panel, with slight modification, will impose the sanctions the Department requests.

In reaching the conclusion that Laymon should be barred from acting in a supervisory role in the future, the Hearing Panel first looked to the principal considerations set forth in the Sanction Guidelines. The Hearing Panel noted: (1) Laymon ignored "red flag" warnings that should have resulted in additional supervisory scrutiny of Dunn's activities; (2) Laymon engaged in the misconduct for almost a full year; (3) Laymon's actions were reckless or deliberate; and (4) although Laymon admitted his guilt just before the hearing, he has not accepted fully his responsibility for his supervisory failures.

With respect to the last point, the Hearing Panel was troubled by Laymon's vague and often contradictory testimony. On critical points, Laymon tried to disavow his earlier sworn testimony and his written submissions to both NASD and the Securities and Commission. For example, Laymon took the position at the hearing that he was unaware of Dunn's activities. In particular, Laymon repeatedly stated that he had not received copies of Dunn's account records from J. Alexander. But, before the hearing, Laymon repeatedly had stated just the opposite. In a letter Laymon wrote in response to NASD in October 1998, Laymon admitted that "Dunn discussed his desire to sell the FFAC trust certificates prior to joining Magellan."[61] Laymon went on to explain that he approved this activity because Dunn's former firm had "done their due-diligence and approved their representatives to market FFAC certificates. After [Dunn]

[61] CX–22, at 4.

transferred to Magellan he discussed with me his selling of the stocks prior to making any sales of the shares."[62]

In an August 12, 1998, letter to the Commission, Laymon provided further detail of his knowledge of Dunn's activities. Laymon told the Commission that "Dunn discussed issues related to [FFAC] with [its] management on a regular bi-weekly basis, and then discussed those issues with me as they progressed."[63] Laymon also related in considerable detail the steps he and Dunn took to investigate problems at FFAC as they became known. This response clearly shows that Laymon had far more knowledge about Dunn's sales activities than Laymon was willing to admit at the hearing.

Further, in February 1999, Laymon wrote a letter to the Oregon Department of Consumer and Business Services–Division of Finance and Corporate Securities in which he defended Dunn's sale of FFAC stock from his own portfolio.[64] Laymon described this process as "designed to get lower prices to [Dunn's] clients (by using a market maker) and a reasonable profit to [Dunn], by collecting the 5% fee" that otherwise would be collected by Magellan's clearing firm.[65] In this defense, there is no hint that Dunn has acted improperly or without Laymon's knowledge.

Laymon further testified in a deposition before the Oregon Department of Consumer and Business Services–Division of Finance and Corporate Securities on February 5, 1999, that he had received copies of documents relating to Dunn's sales of FFAC stock.[66] Likewise, Laymon

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[62] *Id.* (emphasis added).

[63] CX–23, at 4.

[64] CX–24, at 2.

[65] *Id.*

[66] CX–27, at 21.

admitted in his deposition that he had received account information directly from the broker-dealers with whom Dunn had accounts.[67] But, in Laymon's words, he just did not pay much attention to those documents.

The Hearing Panel also considered Laymon's testimony about his current supervisory practices in light of his deficient supervision of Dunn. In particular, the Hearing Panel inquired about Laymon's current supervisory procedures relating to his review of correspondence. The Hearing Panel wanted to judge whether Laymon had learned anything from his experience with Dunn. Although Laymon professed that he now reviews every piece of correspondence sent or received by Magellan's registered representatives, it was evident to the Hearing Panel that Laymon still had not established a system of checks and balances to assure that his subordinates provided him with copies of all their correspondence. To the contrary, Laymon's response showed that he relied on the representatives to supply him with copies of their correspondence.[68]

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[67] *Id*. at 21–22.

[68] Laymon testified on questioning by the Hearing Panel as follows:

> Q. How do you ensure that you see every piece of correspondence that's sent to every client?
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> A. That's a very good question. It's difficult to see everything, as you know.
>
> Q. So what are your procedures?
>
> A. I've got a full-time staff that's been there with me now for two years, they make sure that everything comes through me.
>
> Q. How is that done?
>
> A. I'm sorry?
>
> Q. How is that done?
>
> A. It's a written procedure.
>
> Q. What is the check and balance to protect you against an agent of yours sending something out to a client that has not been approved?
>
> A. They have to provide me with any communications, written communications, that they're going to send out to a prospect and/or client. That is required.
>
> Q. How do you ensure that is done?

Laymon did not have a system that verified that he in fact received copies of all correspondence. Indeed, it appeared to the Hearing Panel that Laymon did not understand the need for such a system.

In summary, the Hearing Panel is convinced that Laymon represents an unacceptable risk to his Firm's customers if he is left in a supervisory role. Laymon has demonstrated repeatedly that either he is incapable or unwilling to devote the time and resources necessary to assure proper compliance with all applicable rules and regulations. Accordingly, the Hearing Panel adopts the Department's recommendation to bar Laymon as a supervisor. The Hearing Panel further concludes that Laymon should be suspended for two years as a registered principal and that he should be required to requalify by examination as a principal. Moreover, the Hearing Panel concludes that a $20,000 fine imposed on the Firm and Laymon, jointly and severally, is appropriate. Finally, the Hearing Panel concludes that Magellan should be censured for its failures. Although Laymon was Dunn's supervisor, ultimately the duty of reasonable supervision rests with the member firm.

In determining the foregoing sanctions, the Hearing Panel has considered the factors the Respondents presented in mitigation. However, the Hearing Panel does not find these factors to be sufficiently mitigating to warrant lesser sanctions. In particular, the Hearing Panel notes that the evidence showing that Magellan updated its compliance manual and initiated on-site inspections for registered representatives at remote locations is not mitigating. Rather, these are minimum requirements expected of all member firms. Furthermore, as discussed above, the

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A. That's very difficult. The only way I can do it is be the mailman and then open the letter. It's very difficult. Very difficult. (Tr. 195–96.)

Hearing Panel does not give great weight to the argument that Laymon accepted responsibility for his failures. While it is true that he admitted liability shortly before the hearing commenced, at the hearing he argued that he was the unknowing victim of Dunn's misconduct. This position is inconsistent with his assertion that he should be given credit for accepting responsibility for his misconduct. Accordingly, the Hearing Panel finds no mitigating factors warranting lesser sanctions.

V. ORDER

Therefore, having considered all the evidence,[69] the Hearing Panel orders as follows:

(1) Laymon is barred as a supervisor and suspended for two years from associating with any member firm in any principal capacity;

(2) Laymon and Magellan are censured and, jointly and severally, fined $20,000;

(3) Laymon is ordered to requalify by examination as a General Securities Principal before he resumes those responsibilities; and

(4) Laymon and Magellan, jointly and severally, are ordered to pay the costs of this proceeding in the total amount of $1,862.10, which include an administrative fee of $750 and hearing transcript costs of $1,112.10.

These sanctions shall become effective on a date set by the NASD, but not earlier than 30 days after this Decision becomes the final disciplinary action of the NASD, except, if this Decision becomes the final disciplinary action of the NASD, the suspension of Laymon in his capacity as a

[69] The Hearing Panel has considered all of the arguments of the Parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.

General Securities Principal shall commence with the opening of business on Monday, March 3, 2003, and end at the close of business on March 2, 2005.

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Andrew H. Perkins
Hearing Officer
For the Hearing Panel

Copies to:

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