NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. PATRICK ORVIL NUGENT (CRD No. 1498083), Respondent.	Disciplinary Proceeding No. C01040010 Hearing Officer – AWH **Hearing Panel Decision** January 6, 2005

Registered principal barred for participating in private securities transactions without giving prior written notice to, or receiving prior approval from, his member firm, in violation of NASD Conduct Rules 3040 and 2110. Respondent also assessed costs.

Appearances:

David A. Watson, Esq., Mark Graves, Esq. for the Department of Enforcement.

Patrick Orvil Nugent, *pro se.*

DECISION

Background

On May 6, 2004, the Department of Enforcement ("Enforcement") filed the Complaint in this matter, alleging that Patrick Orvil Nugent ("Respondent" or "Nugent") engaged in private securities transactions without giving prior written notice to, or receiving prior approval from, his member firm, in violation of NASD Conduct Rules 3040 and 2110. Alternatively, the Complaint alleges that Nugent engaged in outside business activities without giving prompt written notice to his member firm, in violation of NASD Conduct Rules 3030 and 2110.

Nugent filed an Answer on July 3, 2004, denying that his conduct constituted a violation of NASD Rules, and requested a hearing. A hearing was held in San Francisco, California, on November 8, 2004, before a hearing panel composed of the Hearing Officer and two current members of the District 1 Committee.

Findings of Fact[1]

From July 1993 to August 2002, Nugent was registered with NASD as a General Securities Principal through member firm Multi-Financial Securities Corporation (MFSC).[2] During that period, he served as the supervisory principal for MFSC's Sunnyvale, California, branch office.[3] On August 5, 2002, MFSC terminated Nugent's employment for selling away from the firm the unapproved promissory notes that are at issue in this proceeding.[4] He is currently registered as a General Securities Principal with member firm United Securities Alliance, Inc.[5]

From December 7, 1999, through February 8, 2002, Nugent acted as a finder in connection with the sale of promissory notes issued by the Wynn Company, Inc. (Wynn).[6] Wynn was a Utah corporation engaged in the sale of used automobiles through high-interest (often exceeding 20%) loans to customers with impaired credit ratings. Wynn used the funds raised through selling the promissory notes to finance its operations and intended expansion.[7]

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1 References to Enforcement's exhibits are designated as CX __. The transcript of the hearing is designated Tr. __. Respondent offered no exhibits.

2 CX-1, pp. 2, 5.

3 CX-9, p. 2.

4 CX-1, p. 5, CX-9, p. 2.

5 CX-1, pp. 1-2.

6 CX-4, p. 3.

7 Its stated purpose in issuing the Wynn notes was to "enlarge their customer base in the automobile sales industry" by "aggressively seeking and securing private capital to expand the growing business…" CX-8, p. 2. The interest paid to the investor is said to represent "the privilege of using your money over a set period of time." *Id*. at 4.

Over a two-year period, Nugent referred 25 customers to Wynn, all of whom were MFSC customers.[8] Those customers purchased Wynn promissory notes having a total value of $1,498,504.41.[9] Wynn paid Nugent $61,938 for those referrals.[10] The Wynn promotional materials describe the promissory note offered as a "Secured Commercial Note" or an "Enhanced Automobile Receivable," paying a nine-percent interest rate, and having a nine-month maturity.[11] At maturity, the investor could liquidate the note, repurchase it, or invest an additional amount. The interest rate would increase to 10 percent on repurchased notes, even with funds added.[12] However, some of the promissory notes that were actually issued bore a 12-month maturity date and provided interest rates of from nine to eleven percent.[13] The notes also gave the holder of the note the option of extending the maturity date to double its original length, and, if the holder failed to exercise that option, Wynn could double the term of the note at its discretion.[14]

The investor received a promissory note and an Assignment of Payments ("Assignment") from Wynn.[15] In the Assignment, Wynn pledged to secure the note through both "the stream of income" generated by the sales of automobile and truck contracts, a list of which was purportedly attached to the Assignment, and the titles to the vehicles that were noted on that attached list.[16] In fact, the customers never received a list of specific contracts and vehicles because the list was continually changing whenever

[8] Tr. 73.
[9] CX-4, p. 3, Tr. 56.
[10] Tr. 56.
[11] CX-8, p. 2, 4.
[12] CX-8, p. 7.
[13] CX-4, pp. 3-5, CX 6, p. 14, CX-7, p. 2.
[14] CX-6, p. 1; CX-7, p. 2.
[15] CX-6.
[16] *Id.*, p. 2.

a vehicle purchaser paid off the loan or defaulted on loan payments.[17] The collateral was purportedly held by an escrow agent who was to ensure that the value of the collateral continually constituted at least 130% of the principal provided by the investor.[18]

Three times in the Spring and early Summer of 2000, Nugent, who had experience as an auditor, performed what he described as an audit at the offices of the escrow agents to verify the existence of the collateral for the promissory notes. Originally, a CPA firm was the escrow agent. Subsequently, the escrow agent was the law firm of Holman, Walker, and Hutchings in Sandy, Utah.[19] During these visits he reviewed files containing, among other things, copies of the investor application for the purchase of the notes, copies of the notes themselves, and the titles to the vehicles constituting the collateral. He examined a sample of five to ten files to determine whether automobile titles were attached to the notes of the different investors. Although he "found everything was in order," he did not determine whether an actual automobile existed for each title in an investor file or verify any title with the appropriate state agency.[20]

By August 2000, Wynn's financial condition began to deteriorate. From September 2000, Wynn stopped paying commissions to Nugent for referring customers.[21] However, Nugent failed to inform his customers of that fact.[22] Rather, from September 2000 through June 2001, he took no action to stop customers from reinvesting their money in Wynn notes, and he continued to refer new customers for the purchase of Wynn

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[17] Tr. 72.
[18] CX-8, p. 5.; Tr. 72.
[19] Tr. 93-99.
[20] Tr. 62-63, 114-15.
[21] Tr. 106-08.
[22] Tr. 110-11.

notes.[23] He failed to take any action even though he had attended an MFSC sales and compliance meeting in May 2001, during which a presentation was made warning of the dangers of promissory notes and advising representatives that they were not an MFSC approved product.[24] Moreover, in July 2001, Nugent assured customer J.S. that he could renew his note because he had recently visited Wynn in Salt Lake City, and that he found that, with respect to the security and financials, " everything is fine at the Wynn Company."[25] However, by November 2001, J.S.'s interest checks began to arrive late, and, after January 2002, he received no payments at all.[26]

Wynn eventually declared bankruptcy in Salt Lake City, and is the subject of a Ponzi scheme investigation by the Federal Bureau of Investigation. Some 840 investors in the notes became general obligation creditors in the bankruptcy proceeding, notwithstanding the purported existence of collateral backing those notes.[27] Nugent concedes that the vehicle titles must have been used as collateral for more than one note, and that the promissory note program had degenerated to the point that the funds of later investors must have been used to pay obligations to earlier investors.

Nugent did not at any time notify or obtain the approval of MFSC prior to engaging in transactions in the notes. The MFSC Compliance Manual states, "A [registered representative] may not raise money, or participate in the raising of money for any company, individual, or venture without the written consent of MFSC."[28] Notwithstanding the injunction of the Compliance Manual, he believed he did not need to

[23] Tr. 15, 108-09, 115-16; CX-4, p. 3.
[24] CX-9, p. 2.
[25] Tr. 15-16. With respect to what he told J.S., Nugent testified at the hearing that "I'm not real sure, that what I told him was the truth." Tr. 112.
[26] Tr. 19.
[27] Tr. 20-21, 100-01. Nugent himself is a creditor in Wynn's bankruptcy proceedings, and is owed over $50,000 in unpaid finder's fees. Tr. 91, 101.
[28] CX-14, p. 3.

notify his firm that he was participating in the sale of the notes because he thought that the notes were not securities. However, the notes were securities, and, even if his conclusion that they were not securities was correct, the Manual plainly precluded him from participating in their sale. In coming to that conclusion, he relied upon oral representations of, and later upon an unsigned, limited opinion letter written by, Jeffrey Walker of the law firm of Holman, Walker & Hutchings. That law firm not only represented Wynn, but it also served as an escrow agent for the collateral purporting to back the notes.[29] The opinion letter specifically states that "the foregoing opinion shall not be relied upon by any party other than [Wynn]….as it has no efficacy to any other party."[30] Nugent noted that language, but it did not affect his determination not to notify MFSC of his participation in the sale of the notes."[31]

Discussion

NASD Conduct Rule 3040 prohibits any person associated with a member from "participat[ing] in any manner in a private securities transaction" unless, prior to engaging in the transaction, the associated person provides "written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction." The Rule defines a private securities transaction as one "outside the regular course or scope of an associated person's employment with a member." Further, when a transaction involves selling compensation, the member firm, after receiving the requisite notice, must either approve or disapprove of the associated person's proposed role.

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[29] Tr. 76-81; CX-13, pp. 4-11.
[30] CX-13, p. 10.
[31] Tr. 77-78.

Here, the sale of Wynn notes was outside of Nugent's scope of employment, and his participation as a finder in the sale of the notes is sufficient to trigger the requirements of Rule 3040.[32] He did not notify MFSC prior to engaging in the Wynn note transactions nor did he receive the firm's approval prior to his receipt of selling compensation in the form of finder's fees.[33] For the reasons that follow, the promissory notes were clearly securities, and, therefore, fall under the purview of Rule 3040.

The term "security" is defined in both § 2(a)(1) of the Securities Act of 1933 and § 3(a)(10) of the Exchange Act of 1934 to include "any note"; however, the Exchange Act excludes from the definition of security any note that matures within nine months.[34] Here, while some of the notes purported to mature in nine months, they would do so only if neither party to the note elected to extend the term for another nine months. Accordingly, none of those notes comes within the exclusion because there is no certainty that the note would mature within nine months. In any event, the exclusion is limited to prime quality commercial paper, not the type of note involved in this proceeding.[35]

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[32] *Dep't of Enforcement v. Abbondante*, 2003 NASD Discip. LEXIS 50 at *26 (OHO Nov. 7, 2003) ("even very limited involvement by an associated person is sufficient to trigger the requirement that the person give notice to the employer."); *Stephen J. Gluckman*, Exchange Act Release No. 41628, 1999 SEC LEXIS 1395 (July 20, 1999) (referring customers and receiving a finder's fee is sufficient to trigger Rule 3040).

[33] CX-13, p. 1-2; Rule 3040(e)(2) expressly includes finder's fees within the definition of selling compensation.

[34] Section 3(a)(3) of the Securities Act exempts from registration a note that "arises out of a current transaction" and matures within nine months. The Supreme Court has consistently held the definitions in the two Acts to be virtually identical.

[35] *SEC v. R.G. Reynolds Enterprises, Inc*., 952 F.2d 1125, 1132 (9th Cir. 1991) ("The legislative history of the 1933 Act indicates that the exemption 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.'"); *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 paper of a type not ordinarily purchased by the general public); *Zeller v. Bogue Electric Manufacturing Corp*., 476 F.2d 795, 800 (2nd Cir. 1973) (exemption applies only to prime quality negotiable paper); *Stephen J. Gluckman*, 1999 SEC LEXIS 1395 at *12 (notes not excluded from definition of a security merely because they had a maturity date of less than nine months); *Minotaur Capital, Inc.*, Exchange Act Release No. 42155, 1999 SEC LEXIS 2453 at *7 (Nov. 18, 1999); *Dep't of Enforcement v. Chris Dinh Hartley*, 2003 NASD Discip. LEXIS 49 at *13-14 (NAC Dec. 3, 2003) *aff'd* Exchange Act Release No. 50031, 2004 SEC LEXIS 1507 (July 16, 2004); *Dep't of Enforcement v. Brian J. Clark*, 2003 NASD Discip. LEXIS 33 at *17 (OHO Aug. 6, 2003).

In *Reves v. Ernst & Young*, the Supreme Court adopted a version of the "family resemblance" test to "distinguish, on the basis of all of the circumstances surrounding the transactions, notes issued in an investment context (which are "securities") from notes issued in a commercial or consumer context (which are not)."[36] The Court began its analysis with the rebuttable presumption that a note is a security.[37] The presumption is rebutted if a note is of a category of judicially created exceptions, or if it bears a strong "family resemblance" to an item on the list of judicially crafted exceptions.[38] The court set out four factors for assessing the resemblance of a particular note to one of those exceptions:

> (1) the motivations of the purchaser and seller of an instrument − "If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a 'security.'";
>
> (2) the plan of distribution − notes that are "offered and sold to a broad segment of the public" are likely to be securities;
>
> (3) the reasonable expectations of the investing public − if the notes are characterized as "investments," and there is no reason to question that characterization, they are likely to be found to be securities; and

[36] 494 U.S. 56, 63 (1990).
[37] *Id*. at 65.
[38] *Reves*, 494 U.S. at 67.

> (4) "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary."[39]

The Wynn notes do not resemble any of the instruments that the Court identified as exempt from the definition of a security, and there is no basis for adding the Wynn notes to the list of non-securities. The purpose of the notes was to raise operational and expansion capital for Wynn's business, and the investors were motivated by the high interest rate offered by the notes. The notes were sold broadly to the public; Nugent, himself, solicited a total of 25 investors to purchase 50 promissory notes, and 840 investors in the notes became creditors in Wynn's bankruptcy proceeding. The purchasers reasonably considered that they were making an investment, and could add to that investment. Finally, the notes were not subject to any scheme of regulation other than the securities laws. Accordingly, the Hearing Panel concludes that the Wynn notes were securities, and that Nugent violated NASD Conduct Rules 3040 and 2110 by selling securities for compensation without giving MFSC prior written notice or receiving MFSC's prior written approval.[40]

Sanctions

The NASD Sanction Guidelines for selling away recommend a fine ranging from $5,000 to $50,000, and a suspension that varies in length according to the dollar amount of sales. Here, where the amount is over $1 million, the Guidelines recommend a

[39] *Id*. at 66-69.

[40] Even if the Hearing Panel were unable to conclude that the notes were securities, under the alternative theory of the Complaint, the Hearing Panel would find that Nugent violated NASD Conduct Rules 3030 and 2110 by engaging in unapproved outside business activities.

suspension of one year to a bar; the presence of aggravating or mitigating circumstances may raise or lower that sanction.[41]

In determining that this is an egregious case and warrants the sanction of a bar, the Hearing Panel finds several principal considerations listed in the Guidelines to be applicable. The dollar volume of sales was great, the number of customers was large, and the length of time over which the selling activity occurred was long. Nugent's selling away activity involved customers of his firm who likely suffered substantial monetary losses as unsecured creditors in Wynn's bankruptcy proceeding. Nugent, a supervisory principal at MFSC, gave no verbal notice to the firm, and he continued to engage in his misconduct even after attending a compliance meeting at the firm, at which employees were warned of the dangers of promissory notes, and reminded that they were not products approved for sale by the firm. Finally, the Hearing Panel finds Nugent's misconduct to be particularly egregious because he knew, as early as September 2000, that Wynn was in financial difficulty, yet he continued to refer new customers to Wynn and told existing customers that Wynn's finances and operations were "fine."

At the hearing, Nugent admitted that his conduct was inappropriate, but claimed that he misinterpreted the rules regarding selling away, and believed that, because he thought the notes were not securities, he was not obliged to notify the firm of his participation in their sales. That claim rings hollow in light of the firm's explicit warning about promissory notes. Moreover, "as a registered person and principal in the securities industry," he "is assumed as a matter of law to have read and had knowledge of

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[41]NASD SANCTION GUIDELINES, at p. 17 (2004 ed.).

NASD's Rules and the standards in the securities industry."[42] Finally, he cannot properly claim reliance on advice of counsel for Wynn. Walker was not his counsel, and Walker's "opinion" clearly stated that it had no efficacy to any party other than Wynn. Accordingly, the Hearing Panel finds that there are no mitigating factors that would justify a sanction less than a bar. In light of the bar, the Hearing Panel will not impose a fine.[43]

Conclusion

Patrick Orvil Nugent is barred from associating with any member firm in any capacity for engaging in private securities transactions without giving prior written notice to, or receiving prior approval from, his member firm, in violation of NASD Conduct Rules 3040 and 2110. In addition, he is ordered to pay costs in the total amount of $1,754.50, consisting of a $750 administrative fee and a $1,004.50 transcript fee.

The sanctions shall become effective on a date determined by NASD, but not sooner than 30 days from the date this Decision becomes the final disciplinary action of

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[42] *Department of Enforcement v. U.S. Rica Financial, Inc.*, No. C01000003, 2003 NASD Discip. LEXIS 24, at *39 n.11 (NAC Sept. 9, 2003) (citation omitted).

[43] Enforcement seeks an order requiring Nugent to disgorge his total commissions and pay them, on a pro rata basis, to his customers. However, an order that a respondent pay money to his customers is an order of restitution, not disgorgement. The Guideline for private securities transactions does not recommend that adjudicators consider ordering restitution or partial restitution to customers. *See Department of Enforcement v. Roger A. Hanson*, No. C8A000059, 2002 NASD Discip. LEXIS 5, at *4 (NAC Mar. 28, 2002). In any event, the customers may recover a portion of their losses in the Wynn bankruptcy proceeding, and no order of restitution would be appropriate here because there is no evidence in this record of a "quantifiable" loss by any customer, as required by the General Principals Applicable to All Sanction Determinations contained in the Guidelines .

NASD, except that the bar shall become effective immediately if this Decision becomes the final disciplinary action of NASD.

Alan W. Heifetz
Hearing Officer
For the Hearing Panel

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