BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

Department of Enforcement, Complainant, vs. Timothy James Fergus Lisle, IL Frank Thomas Devine Oswego, IL and Richard Alan Blake DeKalb, IL, Respondents.	Decision Complaint No. C8A990025 Dated: May 17, 2001

Registered representatives engaged in private securities transactions without providing prior written notice to and obtaining prior written approval from the NASD member firm with which they were associated. Held, findings affirmed and sanctions modified.

We called this matter pursuant to NASD Rule 9312 to review the findings and sanctions of the June 13, 2000 decision of an NASD Regulation, Inc. ("NASD Regulation") Hearing Panel against respondents Timothy James Fergus ("Fergus"), Frank Thomas Devine ("Devine"), and Richard Alan Blake ("Blake"). We affirm the Hearing Panel's findings that Fergus, Devine, and Blake engaged in private securities transactions without providing prior written notification to and obtaining approval from their employer, in violation of Conduct Rules 3040 and 2110. We modify the Hearing Panel's sanctions by increasing the suspension period for each respondent and otherwise affirm the remaining sanctions. Accordingly, we order that Fergus pay an $8,000 fine, be suspended for 60 days in any capacity, and requalify by examination as an investment company and variable contracts products representative; that Devine pay a $34,825.42 fine ($25,000 plus disgorgement of $9,825.42 in commissions), be suspended for 90 days in any capacity, and requalify by examination as an investment company and variable contracts products representative; and that Blake pay a $35,000 fine, be suspended for 180 days in any capacity, and requalify by examination as an investment company and variable contracts products representative. We also order the respondents each to pay $1,414.28 in costs imposed by the Hearing Panel.

We called this matter to review the findings and sanctions imposed by the Hearing Panel, and in particular, to review whether the Hearing Panel appropriately analyzed the numerous mitigating and aggravating factors in this case. The respondents admit that they engaged in the private transactions at issue in this case, but they argue that the transactions did not involve a security. We first describe the facts surrounding the respondents' sales and their dealings with various attorneys upon whose advice they argue they relied. We also describe the facts surrounding the respondents' claimed mitigation, including their receipt of a compliance bulletin issued by the firm's insurance affiliate, their purported oral notice to a supervisor, and their efforts to investigate the issuer and to obtain a return of client funds. We next address whether the transactions involved a security, a necessary finding for a Rule 3040 violation. Finally, we address the Hearing Panel's findings and respondents' arguments regarding the several mitigating and aggravating factors present in this case.

I. Background

Fergus, Devine, and Blake were investment company and variable contracts products representatives registered with U.S. Life Equity Sales Corp. ("US Life Equity"), a broker-dealer subsidiary of U.S. Life Corporation ("US Life Corp."). The respondents also were employed by US Life Corp.'s insurance subsidiary, All American Life Insurance Company ("All American").[1] In April 1997, U.S. Life Equity filed Uniform Termination Notices for Securities Industry Registration ("Forms U-5"), reporting that the respondents had been terminated for "unauthorized and undisclosed outside business activities" for selling investments involving Personal Choice Opportunities, Inc. ("PCO"), a company involved in the viatical settlement business, without notifying the firm. NASD Regulation subsequently began an investigation of the respondents that culminated in this proceeding.[2]

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[1] Fergus, Devine, and Blake were associated with US Life Equity as investment company and variable contract products representatives from October 1996 to April 1997, from January 1994 to April 1997, and from January 1996 to April 1997, respectively. The respondents currently are employed by another member firm.

[2] The Department of Enforcement filed three separate complaints against the respondents on March 12, 1999. Each complaint contained one cause of action alleging that between February and March 1997, the named respondent offered and sold to customers, for compensation, securities in the form of PCO promissory notes without prior written notice to, and approval of, his employer, US Life Equity, in violation of Conduct Rules 2110 and 3040. The Chief Hearing Officer issued a notice proposing to consolidate the three complaints, and after considering the respondents' arguments in opposition, the Chief Hearing Officer issued an order consolidating the complaints on May 11, 1999. We affirm the Chief Hearing Officer's ruling for the reasons stated in her order.

The respondents admit that from February through March 1997, they solicited investors for the PCO investment without notifying US Life Equity. Blake admits that he solicited 20 investors who invested $1.7 million, resulting in commissions to him of $14,450. Devine admits that he solicited five customers who invested $898,749.50, resulting in commissions to him of $19,661.92. Similarly, Fergus admits that he solicited three customers who invested $132,950.15, although he received no commissions on the sales. Five of Blake's PCO investors were also customers of US Life Equity. None of Devine's or Fergus' PCO investors were customers of US Life Equity.[3]

Shortly after the respondents began selling the PCO investment, on April 2, 1997, federal prosecutors in the Southern District of New York filed a complaint against David Laing ("Laing"), the president of PCO, and three others involved in PCO, alleging that they fraudulently induced more than 950 investors to invest in the PCO investment. By court order entered on September 18, 1998, Laing pleaded guilty to securities fraud and mail fraud and was sentenced to 96 months in prison and ordered to pay restitution. See United States v. David Laing, No. 97-0638 (S.D.N.Y. Sept. 18, 1998). In addition, the California Department of Corporations and the Securities and Exchange Commission (the "SEC") filed complaints against Laing and PCO.[4] In April 1997, at the request of the California Department of Corporations, the Los Angeles Superior Court appointed a receiver to oversee investor claims for reimbursement.

A. Respondent Blake

At the time of the hearing below, Blake had been an insurance agent for 23 years, and he had first qualified as an investment company and variable contracts products representative in 1974. Blake worked as a "captive" agent of Metropolitan Life Insurance

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[3] The respondents argue that they believed that the PCO investment represented an insurance product, because PCO was involved in the viatical settlement business. In a typical viatical settlement contract, a terminally ill person sells the death benefits payable under his life insurance policy to an investor at a price representing the discounted value of the benefits payable under the policy, thereby allowing the terminally ill individual to obtain immediate funds. When the insured dies, the investor collects the death benefits.

[4] On November 13, 1997, the SEC filed a complaint in the Southern District of New York alleging that Laing and PCO "fraudulently raised approximately $95 million from investors nationwide by offering and selling securities in the form of investments in a loan program offered by PCO." The complaint further alleged that Laing and PCO "falsely represented that they would use the proceeds of the sales of the PCO Loan Program to make investments in viatical settlements . . . . [and that Laing and PCO] misappropriated and otherwise misused the proceeds of the offering." On February 17, 1999, the Court entered a final consent judgment in which Laing consented to being enjoined from violations of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933, and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

Company ("MetLife") until 1995,[5] when he left to become an independent agent. In 1995, Blake was introduced to Barry Link ("Link"), a supervisor at All American,[6] and Blake began working as an All American insurance agent and as a registered representative of US Life Equity.[7] In addition, as an independent insurance contractor, Blake entered into agent agreements with other carriers of insurance products. Blake testified that he was not required to report to US Life Equity sales of products not sold through All American.[8]

In 1996, Blake became interested in viatical settlement contracts after seeing them advertised in a magazine. He subsequently obtained marketing materials for a viatical settlement company other than PCO. According to Blake, after an All American sales meeting involving Link, Blake gave Link a copy of the materials, and they discussed the product generally. Blake also testified that in November 1996, at an All American convention, Link asked Blake if he had begun selling viatical products. Blake later obtained marketing materials from PCO, and in early 1997, he provided copies of the PCO materials to Devine and Fergus at one of their regular coffee shop meetings.

1. Attorney F.L.'s Purported Legal Advice

Blake also testified that on January 20, 1997, he approached his neighbor, F.L., an attorney, to get his views on the PCO investment. Blake gave F.L. copies of the PCO documents, including a legal opinion contained in the PCO materials written by J.R. ("J.R. legal opinion"), and a copy of a decision of the Court of Appeals for the District of Columbia Circuit in SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir.), reh'g denied, 102 F.3d 587 (D.C. Cir. 1996) ("Life Partners"), which held that the viatical settlement contracts at issue in that case were not securities.

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5 Blake testified that as a "captive" agent, he was permitted to sell only MetLife products.

6 Devine, who worked with Blake and Fergus at MetLife, introduced Blake to Link. Link became the general agent in charge of the respondents at All American and had certain securities compliance responsibilities, such as arranging annual compliance meetings with representatives. When the respondents sold All American products, Link received overrides on those sales.

7 US Life Equity's representative agreement required its registered representatives to be affiliated with one of the insurance subsidiaries of US Life Equity's holding company.

8 Randolph Hill ("Hill"), the compliance officer at US Life Equity, testified that the respondents were not required to report to US Life Equity sales of insurance products. US Life Equity's annual compliance questionnaire required representatives to report affiliations with insurance companies and to list any benefit received from any source other than from insurance or securities transactions. See footnote 37, infra.

On approximately February 13, 1997, F.L. told Blake that the J.R. legal opinion in the PCO materials accurately described the holding of Life Partners that viatical settlements were not securities. According to Blake, F.L. stated that he would have written the J.R. legal opinion differently, but that it was "fine." F.L. also requested that Blake send the PCO documents to F.L.'s friend, D.S., who also was an attorney, for his views.[9] On February 25, 1997, F.L. invested $85,000 in PCO.[10]

On January 27, 1997, Blake entered into an Agent Commission Agreement with M.D. Smith & Company ("MD Smith"), PCO's marketing arm, in which he agreed to "endeavor to find [l]enders for PCO" for a four-percent commission rate on the "[l]ender's deposit."[11]

2. The All American Bulletin

On January 29, 1997, All American issued a bulletin (the "Bulletin") to its insurance agents, including the respondents, regarding sales of viatical settlements. The Bulletin stated:

> The All American Life Insurance Company is philosophically opposed to the use of viatical settlements. We believe that accelerated death benefit provisions are a better method of achieving this end, and can do so at less cost to the policyholder. As you and your producers are independent contractors, we would not dictate to you how to conduct your business, except as it affects our company. In that regard the following restrictions apply to any agent of All American Life Insurance Company:
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> 1. The agent may not solicit insureds of our company for viatical settlements.

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9 At F.L.'s request, Blake sent D.S., an attorney practicing corporate law and estate planning and trust law, a copy of the PCO materials and the Life Partners decision. F.L. testified that D.S. informed him that the PCO investment appeared to be a security and had attributes of a "Ponzi scheme." F.L. also testified that he informed Blake of D.S.'s remarks. In contrast, Blake testified that when he questioned F.L. about whether D.S. had any "problem" with the PCO materials, F.L. responded: "Not really."

10 After Devine attended a PCO meeting in Colorado in February 1997, he advised F.L. in a brief telephone conversation that PCO was a legitimate company. F.L. ultimately invested in the PCO investment. In March 1997, F.L. approached Blake and asked for a reimbursement of the $738 in commissions that F.L. had paid in order to liquidate certain bonds to invest in the PCO investment. Blake paid F.L. the commissions.

11 Blake ultimately received a five-percent commission rate from MD Smith.

2. In no manner or form can it appear that All American Life Insurance Company is sponsoring the use of viatical settlements.

3. The agent cannot advertise any affiliation with All American Life Insurance Company in the course of doing viatical settlements.

4. Any breach of these guidelines violates the General Agent Agreement and is cause for termination.

Blake testified that he interpreted the Bulletin to permit All American agents who were independent insurance contractors to sell viatical settlements if they abided by the restrictions set forth in the Bulletin.

In February and March 1997, Blake sold the PCO investment to 19 customers who invested $1.7 million in the program,[12] and Blake earned commissions of $14,450.[13] Blake testified that he was his own first customer, and that he invested $133,674 from his individual retirement account ("IRA"). He also testified that family and friends invested in the PCO investment.

On about April 7, 1997, Blake learned from Devine that individuals involved in the PCO investment program had been arraigned. Blake testified that he contacted his customers to inform them of the news of the arraignment and to advise them to stop payments to PCO. He also wrote a letter to the PCO receiver detailing amounts he and his customers had invested, and he assisted his customers in completing claims forms for the receiver.

B. Respondent Devine

At the time of the hearing, Devine had been an insurance agent for approximately 10 years. He worked as a comptroller and officer of an accounting company until Blake persuaded him to join MetLife in 1989, where he became a "captive" agent. Devine became registered as an investment company and variable contracts products representative in 1990, but he never sold a security while employed by MetLife. He left MetLife in 1994 because he wanted to be an independent insurance agent. Devine testified that Link, who he knew from prior business dealings, introduced him to All American. Devine joined All American in

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[12] Five of Blake's customers cashed out annuity policies cited on US Life Equity's approved product list in order to invest in the PCO investment.

[13] The PCO receiver withheld Blake's commissions when returning to him portions of his original investment. Blake testified that the PCO receiver had returned to investors approximately 66 percent of their original investments.

1994, and later became registered with US Life Equity. Devine testified that in late 1996, Link introduced him to viaticals and provided him with the marketing materials for a viatical settlement company other than PCO. According to Devine, they generally discussed the advantages of the product, but never discussed whether it might be a security.

In early 1997, Devine met Blake and Fergus for one of their routine coffee shop meetings. Devine mentioned that Link had introduced him to viatical settlement products. Blake responded that he had given the information on viatical settlements to Link. Blake also informed Fergus and Devine about the PCO investments, and he gave them copies of the PCO materials.

Devine also received the All American Bulletin regarding sales of viatical settlements. He telephoned John Champion ("Champion"), a vice president of marketing at All American, who confirmed that All American agents were restricted from selling viatical settlements to All American customers. Devine testified that he believed that the Bulletin allowed him to sell viatical settlement products. He also testified that he thought the PCO investment was an insurance product because All American, the insurance subsidiary, had issued the Bulletin.

1. Devine's Efforts to Investigate the Issuer and the PCO Investment

Devine subsequently contacted MD Smith directly to obtain a complete set of PCO materials. In addition to reviewing the PCO materials, over the next few weeks, he conducted a number of Internet searches for information concerning viatical settlements. He contacted the Better Business Bureau, the California State Department of Corporations, the National Association of Viaticals, and the American Association of Viaticals regarding PCO and Escrow Plus, Inc. ("Escrow Plus"), PCO's escrow agent. Devine learned that PCO had a pending membership application with the American Association of Viaticals. He discovered that there were no complaints regarding PCO or Escrow Plus, and he relayed the results of his searches to Blake and Fergus.[14]

On February 22 and 23, 1997, Devine attended a PCO meeting in Denver, Colorado. At the meeting, Devine met Laing, Valerie Jenkins ("Jenkins"), the President of Escrow Plus, Michael Smith ("Smith") of MD Smith, and certain individuals who had sold the PCO investments. The individuals reported that their clients had received their semi-annual interest checks on time. Devine testified that participants repeatedly raised the question of whether the PCO investment was a security and were informed that the investment was not a security based on the <u>Life Partners</u> decision. Devine also testified that he discussed whether the PCO investment was a security with G.S., counsel for PCO, who stated that the investments were insurance products and not securities. Devine testified that he was particularly impressed with G.S. because he was a former prosecutor for the City of Denver.

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14 Devine testified that Blake informed him of F.L.'s views regarding the J.R. legal opinion and of F.L.'s intention to invest in the PCO investment.

He also testified that he was impressed with Jenkins, of Escrow Plus, who appeared to be a successful businesswoman. Upon returning from Denver, Devine reported to Blake and Fergus that he thought PCO was a legitimate company and that the PCO investments were not securities.[15]

Before Devine attended the Colorado meeting, he executed on February 10, 1997, an agent commission agreement with MD Smith to "endeavor to find [l]enders for PCO" for a five-percent commission "on the [l]ender's deposit." Subsequently, Devine began soliciting investors for PCO, and five customers invested funds totaling $898,749.90. Devine received commissions of $19,661.92.[16]

On April 7, 1997, Devine discovered on the Internet that some of PCO's officers had been arrested for fraud. Devine called Blake and Fergus to inform them of the news, and to see if there was any way they could stop their customers' payments to PCO. Devine testified that he called the California Department of Corporations and spoke with an attorney who requested that he prepare a letter estimating the amounts invested to assist the Department in freezing Laing's assets. Devine sent a letter to the Department, and he subsequently assisted his customers in filling out claim forms for the PCO receiver.

C. <u>Respondent Fergus</u>

Fergus became an insurance agent in 1989 with MetLife as a "captive" agent. He qualified as an investment company and variable contracts products representative in 1989. In 1996, he decided to leave MetLife in order to offer his clients a larger variety of products. He joined All American and US Life Equity in October 1996 as an independent insurance agent and an independent contractor. Fergus testified that he first contacted some viatical settlement companies after Link told him to look into selling viatical settlements because they provided a good rate of return without stock-market risk. In January 1997, he received the PCO materials from Blake, and he subsequently contacted MD Smith directly to ensure that he had a complete set of PCO materials. On February 10, 1997, he signed an agent agreement with MD Smith entitling him to receive a five-percent commission rate. Fergus testified that in addition to his review of the PCO materials, he evaluated the PCO investment based on his discussions with Blake and Devine regarding Devine's meeting with PCO in Denver and Blake's discussions with F.L.

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15 Devine also testified that he provided the PCO information to J.S., an agent with whom he worked at MetLife, who reviewed the PCO investments with an attorney. J.S.'s attorney provided a letter indicating that there were some issues regarding the usury law in the State of Michigan. Devine raised the issue with G.S., counsel for PCO, who responded by letter advising that investors should not be concerned with the usury issue.

16 Devine paid the PCO receiver $9,836.50 of his commissions from the PCO sales. He therefore has retained $9,825.42 in commissions.

Fergus testified that in January 1997, he received the All American Bulletin and thought that the Bulletin permitted him to sell viatical settlements as long as he abided by the Bulletin's restrictions. In February and March of 1997, he began selling the PCO investment and he personally invested $65,000 from his IRA account. He successfully solicited three customers, who invested $132,950.15. Fergus did not receive a commission check from PCO.

On April 9, 1997, Fergus attempted to contact MD Smith by phone and received no answer. Blake and Devine then informed him that PCO principals had been indicted for fraud. In May 1997, Fergus prepared a letter to the PCO receiver listing amounts invested by his customers and he assisted customers in completing claims forms.

II. Discussion

A. Conduct Rule 3040

Conduct Rule 3040 prohibits associated persons from participating in any manner in a securities transaction outside their regular course of employment with a member firm, without providing prior written notice to and receiving prior written approval from the member firm. If the associated person is to receive selling compensation, he must provide his firm written notice describing in detail the proposed transaction. If the firm approves the participation, the firm must record the transaction on its books and records and supervise "as if the transaction were executed on behalf of the member." Whether a respondent intended to violate Rule 3040 is irrelevant to a finding of violation, but may bear on the issue of sanctions. Rule 3040 serves an important function of protecting investors from the hazards of unmonitored sales and protecting firms from exposure to loss and litigation.

Respondents stipulated that they failed to provide written notice to US Life Equity of their sales of the PCO investments. The central issue in this case therefore is whether the PCO investment was a security, a threshold requirement for a finding of violation under Rule 3040. For the reasons discussed below, we find that the PCO investment was a security, and we affirm the Hearing Panel's finding of violation as to all three respondents. We first describe the PCO investment as set forth in PCO materials, and secondly, we analyze whether the PCO investment was a security under the federal securities laws.

B. The PCO Loan Agreement and Other Documents

PCO was owned and operated by its president, Laing, and was marketed as a company involved in the viatical settlement business. According to PCO's marketing literature and documents, PCO would purchase a dying insured's policy at a discount, and the insured would make an irrevocable assignment of the policy to PCO or Laing.[17] PCO

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[17] PCO's marketing materials represented that a PCO representative would meet with a terminally ill person owning a "paid up group policy" that he or she wanted to sell. After verification of the policy, the seller would undergo a medical examination by a PCO physician who would also review medical records and give a prognosis. PCO would only purchase

borrowed funds from investors, representing that the funds would be used to purchase dying insureds' insurance policies. Investor funds were held in an escrow account until PCO provided certain required documentation. Upon the death of the insured, the death benefits were paid to Escrow Plus and pooled in an escrow account. PCO agreed to pay interest semi-annually at an annual rate of 21 or 25 percent, and to return the principal to investors after one year.

The principal investment documents between PCO and the investor consisted of the following: The Lender Agreement, the Deposit Receipt and Instructions, the Escrow Agreement, and the Lender Acknowledgment.

1. Lender Agreement

Investors signed a Lender Agreement in which they agreed to loan money to PCO for a term of one year "for the purpose of carrying out its business . . . of purchasing group life insurance policies from insureds who [were] persons suffering from terminal illness and [had] six months or less to live."[18] The Agreement specified the amount of funds lent to PCO and provided that the investor would deposit funds into the Escrow Plus account (the "Escrow Account") at Home Savings Bank of America. The Agreement provided that PCO would use all or a portion of the loan proceeds to purchase the insurance policies and to pay PCO agents any fees or commissions. The Agreement further provided that "concurrent" with the deposit of the Lenders' funds into the Escrow Account, PCO would deposit verification of insurance policies' face values and certain other documents into the Escrow Account. The Agreement provided that a 25 percent interest payment would be paid to the Lender from the Escrow Account either semi-annually or at the end of the loan term.[19] At the end of the loan term, principal and "remaining accrued interest" were to be paid to Lenders from the Escrow Account.

2. Deposit Receipt and Instructions

The Deposit Receipt and Instructions instrument documented the exchange and receipt of funds between the investor and Laing and PCO, listed the documents held for

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policies if the seller's life expectancy was six months or less. The policyholder and PCO signed an agreement in which PCO was named 100 percent sole irrevocable beneficiary. PCO then authorized the insurance carrier to pay the proceeds directly to escrow upon the seller's death.

[18] The Loan Agreement provided that the term of the loan was for 12 months, but that the lender could choose to roll over the principal and interest for an additional 12 months to allow PCO to purchase additional policies.

[19] PCO stated that beginning in March 1997, the rate of interest for new investors would change from 25 to 21 percent.

safekeeping by Escrow Plus,[20] and provided for the deposit of lender funds into the Escrow Account. The document stated that "Laing ha[d] authorized the Escrow Account to receive all funds disbursed by the insurance carrier on behalf of David Laing, the designated beneficiary." It instructed Escrow Plus to hold in escrow "the first interest payment for the benefit of the Lender" when PCO delivered verification of the viaticated policy's face value. The "remaining funds from the policy [were to] be disbursed to PCO [but the] Escrow Holder [would first] be allowed to deduct its fee."[21]

3. The Escrow Agreement

The Escrow Agreement was executed by Escrow Plus, Laing and PCO, and the investor. The Escrow Agreement stated that PCO had arranged to borrow funds from the Lender pursuant to the terms of the Lender Agreement, and that "[u]nder the terms of the Lender Agreement, PCO and Lender desire[d] to establish an [Escrow Account] for safekeeping of the documents relating to the purchase of such policies, and for receipt of Lender's funds into the [Escrow Account] for the purchase by PCO of paid up group life insurance policies" and for "payment of commissions." The Agreement provided that "[u]pon release of funds from the Lender and provided the Escrow Holder ha[d] all documents specified in the instructions, funds in the Escrow [Account would] be disbursed to PCO." The Agreement further provided that "[u]pon the death of the seller(s), under the one or more policies purchased by PCO, PCO [would] cause the paying insurance company to deliver its check to the Escrow Holder for deposit in the Escrow Account."

The Escrow Agreement also stated that the "Lender [was] not tied into a specific policy purchase" and that "Lender [understood] that all purchased policies [were] pooled and held as collateral in the Escrow [and that Escrow Holder would] pool beneficiaries' proceeds as sellers expire." The Agreement provided that "[a]t the end of the loan term, Escrow Holder [would] pay Lender's principal and second interest payment from funds in the proceeds pool."

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20 The Deposit Receipt and Instructions listed the following documents to be held in escrow for safekeeping: Verification of Insurance Policy Face Value; Irrevocable Change of Beneficiary Documents; Seller Agreement (Notarized); Medical Records and Diagnosis; Lender Agreement; Deposit Receipt and Instructions; and Laing's Authorization to Insurance Company to Send Beneficiary Funds to Escrow Plus, Inc.

21 The Deposit Receipt and Instructions provided for "[f]urther disbursement from the [Escrow Account to PCO only for the purpose of purchasing] additional policies by PCO or payment of commissions, and upon receipt by Escrow Holder from PCO of new Documents for another transaction." In the event "Escrow Holder disburse[d] further funds, conditioned upon Escrow Holder's receipt of new Documents, no notice of such disbursement, or the receipt by Escrow Holder of New Documents, [would] be given to Lender unless directed to do so in a written instruction from PCO."

4. Lender Acknowledgment

Finally, on the Lender Acknowledgment form, the Lender acknowledged in relevant part that the "loan transaction [was] not an investment as defined by the Securities and Exchange Commission or the [state] Department of Corporations" and [was] "not to be considered a public offering, stock option, private placement or limited partnership."

C. The PCO Investment is a Security

A "security" is defined by the Securities Exchange Act of 1934 ("Exchange Act") as: "any note. . . investment contract . . . or in general, any instrument commonly known as a 'security' . . . but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months." The Supreme Court established tests for determining whether a "note" constitutes a security in Reves v. Ernst & Young, 494 U.S. 56, reh'g denied, 494 U.S. 1092 (1990) ("Reves"), and whether an investment contract constitutes a security in SEC v. W. J. Howey Co., 328 U.S. 293, reh'g denied, 329 U.S. 819 (1946) ("Howey"). As discussed more fully below, we agree with the Hearing Panel that the PCO investment constituted a security under Reves. We also reject respondents' argument that the PCO investment was not a security based on Life Partners, which found that the viatical settlement contract at issue in that case was not a security under the Howey test.

1. The PCO Investment is a Security Under Reves

We agree with the Hearing Panel that the PCO investment constitutes a security under Reves. The Lender Agreement described above is a "note" because it represents a promise by PCO to pay the lender a definite sum of money at a specified time (i.e., interest payments at a 21 or 25 percent interest rate, and a return of principal within one year.) See Black's Law Dictionary 1060 (6th ed. 1990). The "family resemblance" test adopted by the Supreme Court in Reves presumes that a note is a security as defined in Section 3(a)(10) of the Exchange Act unless: (1) it bears a strong resemblance to certain types of notes recognized, based on four factors, as being outside the securities investment market regulated under the securities laws, or (2) it should be added, based on a balancing of the same four factors, to that list of excluded notes. The four factors to be considered when determining whether a note bears a strong resemblance to the types of notes recognized as excluded from the definition of a security are:

(1) the motivations that would prompt a reasonable seller and buyer to enter into the transaction;
(2) the plan of distribution of 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 risk of the instrument so as to make regulation under the securities laws unnecessary. Reves, 494 U.S. at 66-67.

The presumption under the Exchange Act that a note is a security is rebutted only when the "two step, four-factor analysis based on all the evidence leads to the conclusion that the note is not a security." Stoiber v. SEC, 161 F.3d 745, 749 (D.C. Cir. 1998) (holding that two of the four Reves factors in that case "strongly favor[ed]" treating notes as securities). This reflects "Congress' intent to define the term "security" with sufficient breadth to encompass virtually any instrument that might be sold as an investment." Stephen J. Gluckman, Exchange Act Rel. No. 41628, at 5 (July 20, 1998) (citing Trust Co. of Louisiana v. N.N. P., Inc., 104 F.3d 1478, 1489 (5th Cir. 1997), cert. denied, 526 U.S. 1069 (1999)).

We first find that the PCO note does not resemble those notes excluded from the definition of a security.[22] The comparison between the PCO note in question and the notes excluded from the definition of a security is made by considering Reves' four factors. With respect to the first Reves factor -- the motivations that would prompt a reasonable seller and buyer to enter into the transaction -- we find that PCO entered into the transaction to raise working capital for its business of purchasing insurance policies, and the investors loaned the money to PCO with the expectation of profit based on the especially high 21 to 25 percent interest rates.[23] Indeed, Blake testified that he heard that certain investors were upset that the interest rate on the notes was scheduled to decline from 25 to 21 percent in March 1997. Thus, the first Reves factor weighs in favor of finding that the notes are securities.

With respect to the second factor -- the plan of distribution of the notes -- we find that there was "common trading for speculation or investment." The Reves Court held that offer and sale to a "broad segment of the public" establishes the requisite common trading in an instrument. Id. at 68. PCO's plan raised in excess of $90 million from more than 1,500 investors and therefore the notes were broadly distributed. Thus, the second Reves factor weighs in favor of a finding that the notes are securities.

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[22] Reves listed the following notes as excluded from the definition of securities: notes delivered in consumer financing, notes secured by mortgages on homes, short-term notes secured by liens on small businesses or some of the small businesses' assets, notes evidencing "character" loans from banks, short-term notes secured by an assignment of accounts receivable, notes which simply formalize an open-account debt incurred in the ordinary course of business, and notes evidencing loans by commercial banks for current operations. See Reves, 494 U.S. at 65.

[23] Reves emphasized that profit means a "valuable return on an investment" which "undoubtedly includes interest." Reves, 494 U.S. at 68 n.4. 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." Id. at 66-67.

With respect to the third factor -- the reasonable expectations of the investing public as to whether the instruments were securities -- we find that the PCO investors reasonably understood that the notes were "investments" despite the PCO disclaimer stating that the note was "not an investment as defined by the Securities and Exchange Commission." In their testimony, the respondents characterized the PCO notes as "investments." Many of the respondents' customers withdrew funds from their IRAs to fund the investment. Blake, who invested in the PCO notes, described the investment as "much less riskier [sic] than the stock market with almost as high a return or as high a return as you would expect from the stock market." Fergus, who also invested, testified that he reviewed the PCO materials to see if it was "a good investment." Fergus testified that his clients had "expressed interest in getting out of the stock market" and that he thought the PCO investment was a "good opportunity for them to get a good rate of return without stock market risk." F.L. testified that he reviewed the materials as a "potential investor" and decided to invest without regard to the disclaimer in the PCO acknowledgment form that he signed. Accordingly, we agree with the Hearing Panel that the PCO investors reasonably believed that their notes were investments, rather than consumer or commercial loans. Thus, the third Reves factor weighs in favor of finding that the notes are securities.

With respect to the fourth factor -- the presence of any alternative scheme of regulation or other factor that significantly reduces the risk of the instrument so as to make regulation under the securities laws unnecessary -- there is none, but there is a clear need for the protection afforded by the federal securities laws. We find that based on the above four factors, the note does not resemble one of the enumerated types of notes excluded from the definition of a security. We also find that under the second step of the analysis -- whether the note should be added to the list of excluded notes, based on a balancing of the same four factors -- the four factors weigh heavily against the creation of a new category of note outside the protection of the federal securities laws. Accordingly, we find that the PCO notes constitute securities under Reves. [24]

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[24] We reject the respondents' argument that the PCO investment was not a security but was a "secured transaction" because insurance policies were held as collateral for the loans. First, we are not convinced that the PCO agreement created a "security interest" in the insurance policies as defined by Uniform Commercial Code ("UCC") § 1-201 and Article 9. In addition, UCC § 9-203 requires "attachment" for the creation of a security interest by requiring among other things that the debtor have possession of the collateral and/or that the security agreement describe the collateral. The PCO Lender Agreement does neither. More importantly, we find the Reves analysis to be controlling. Consistent with Reves, we find that the PCO notes were securities.

2. The PCO Investment is an Investment Contract Under Howey

Although unnecessary to do so, given our view that Reves controls, we find that the PCO investment also satisfies the Howey test.[25] The Respondents argue that the PCO investment was not a security under Howey. They base this argument on the Life Partners decision, which held that the viatical settlement contract at issue was not a security under Howey.

Howey establishes that an investment contract is a security when investors purchase it with (1) an expectation of profits arising from (2) a common enterprise that (3) depends solely upon the efforts of others. We find, and the respondents do not dispute, that the PCO investment meets the first two elements of Howey in that the investors expected to profit based on a common enterprise consisting of the pooling of the viatical policies' proceeds. The respondents argue, however, that the third element of the Howey test -- that investor profits depend on the efforts of others -- is not satisfied based on the Life Partners decision.

In Life Partners, the investors acquired fractional interests in individual insurance policies. Life Partners engaged in pre-purchase services consisting of evaluating the insured's medical condition, reviewing insurance policies, negotiating purchase prices, and preparing legal documents. Initially, Life Partners was the record owner of the purchased policies "for administrative reasons." In later versions, the investors were the record owners and had a direct contractual relationship with the insurance company. Upon the purchase of a policy, an independent escrow company acting on behalf of Life Partners collected its fee and Life Partners' fee, disbursed funds, and delivered the balance to the insured. After the investors purchased their ownership interests in particular policies, Life Partners provided post-purchase services consisting of: monitoring the insureds' health, assuring that the policies did not lapse, converting group policies into individual policies where required, and arranging for resales of investors' ownership interests in policies.

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[25] We observe that Reves, in adopting the Second Circuit's "family resemblance" approach for determining whether a note is a security, stated:

> "We reject the approaches of those courts that have applied the *Howey* test to notes; *Howey* provides a mechanism for determining whether an instrument is an 'investment contract.' The demand notes here may well not be 'investment contracts,' but that does not mean they are not 'notes.' To hold that a 'note' is not a 'security' unless it meets a test designed for an entirely different variety of instrument would make the Acts' enumeration of many types of instruments superfluous . . . and would be inconsistent with Congress' intent to regulate the entire body of instruments sold as investments."

494 U.S. at 64.

The Life Partners Court held that the third element of Howey -- that profits flow predominantly from the efforts of others -- was not satisfied. The Court found that Life Partners' pre-purchase entrepreneurial services did not establish that investor profits flowed from the efforts of Life Partners. In addition, the Court found that Life Partners' post-purchase services were largely ministerial and did not establish that the investor profits flowed from Life Partners' services. The Court stated that "once the transaction close[d], the investors [did] not look to the efforts of others for their profits because the only variable affecting profits [was] the timing of the insured's death, which [was] outside of [Life Partner's and the escrow company's] control." 87 F.3d at 545. The Court found that the investors' "profits depend[ed] entirely on the mortality of the insured."

Life Partners also developed a program for investors to participate in purchasing viatical settlements through their IRAs even though the Internal Revenue Code prohibits direct investments in life insurance policies by IRAs. Life Partners structured the purchases through separate trusts that Life Partners created for each investor's IRA. The IRAs lent money to the trusts in exchange for non-recourse notes. The trusts used the loans to purchase viatical settlements and the proceeds of the life insurance policies collateralized the loans. When the insureds died, the insurance proceeds were paid to the trusts, and the trusts, in turn, paid the proceeds to the IRAs to discharge the notes.

The Life Partners Court examined the non-recourse promissory notes issued by the investors' trusts to the IRA accounts and found that they too were not securities. The Court stated that because "the underlying viatical contracts are not securities, and because the essential characteristics of the investment are no different whether the purchaser is an IRA or an individual investor, the status of the notes under the 1933 Act does not require extended analysis." 87 F.3d 548. The notes were used in the transactions "merely in order to navigate around certain restrictions in the tax code that preclude IRAs from investing in life insurance contracts" and they were "nothing more than a device" that did "not alter the substance of the transaction in any manner that would suggest a role for the securities laws that is not otherwise indicated by law." Id. at 549.

We find that the PCO investment is distinguishable from the program in Life Partners in that the PCO investment was structured as a loan transaction in which investors were to receive a fixed rate of return on the amount of their investment. Unlike the interests sold by Life Partners, PCO was not selling investors fractional interests in insurance policies. Investors executed loan agreements with PCO to provide funds "for the purpose of carrying out [its] business." In addition, the Escrow Agreement provided that the Lender "[was] not tied to a specific policy purchase" and PCO's obligation under the Lender Agreement to pay investors pursuant to the PCO notes was not adjusted or modified by when a particular insured died, nor were the profits tied to a particular policy. In sum, PCO investors' profits were not dependent "entirely on the mortality of the insured" as was the situation in Life Partners, and investors' profits flowed predominantly from the efforts of PCO in fulfilling its contractual obligations under the Lender Agreement.

The respondents argue that the Hearing Panel misstated the nature of the PCO program when it found that "unlike Life Partners, PCO investors' profits depended not primarily on receipt of insurance proceeds into the Escrow Account but on the entrepreneurial efforts of PCO to attract additional funds to the Escrow Account to repay investors." The respondents point to the parties' stipulation and the PCO documentation, which state that the loans were to be repaid from death benefits sent directly to the Escrow Account after the death of the insured. They argue that because the PCO documentation provides for the Escrow officer to distribute all principal and interest due directly from insurance proceeds in the Escrow Account, investor profits would not flow from the efforts of PCO.

We believe that the investors relied on PCO for their profits as required by the third prong of the Howey test. After the lenders executed agreements with PCO, PCO was required under the Lender Agreement to select, purchase, and deposit into the Escrow Account "group life insurance policies from insureds who [were] suffering from terminal illness and [had] six months or less to live." The Escrow Agreement stated that "[n]o disbursement [of investor funds to PCO would] be made prior to Escrow Holder's receipt of documents confirming that the policy or policies [had] actually been sold and transferred to PCO."

The Escrow Agreement stated that the lender should "understand that all purchased policies [were] pooled and held as collateral in the Escrow [Account]." The Escrow Agreement further stated that "Escrow Holder [would] pool beneficiaries [sic] proceeds as sellers expire" and that "upon the death of the seller(s) under the one or more policies purchased by PCO, PCO would cause the paying insurance company to deliver its check to the Escrow Holder for deposit in the Escrow Account." The PCO materials provided that investor returns would be paid from an "available proceeds capital pool" consisting of the pooled beneficiary proceeds. PCO was the sole party that could select and deposit policies to ensure that investors received their profits from the pooled proceeds of those policies. If PCO failed to deposit policies to satisfy the profits to be paid to investors, the investment would fail. See, e.g., SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9^{th} Cir. 1973), cert. denied, 414 U.S. 821 (1973) (interpreting third prong of Howey test to require that "the efforts made by those other than the investor [be] the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.").[26] Accordingly, the third prong of the Howey test is satisfied here because PCO engaged in entrepreneurial efforts by purchasing and depositing policies into the Escrow Account for the pooling of proceeds from which investor obligations ultimately would be satisfied. [27]

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[26] In addition, the "efforts of others" element of Howey is met even though the PCO Lender Agreement provided for Escrow Plus, and not PCO, to pay investors their profit directly. See Life Partners, 87 F.3d at 545, 548 (examining post-purchase services in terms of services provided by either Life Partners or the escrow company).

[27] In addition, PCO supplied to investors a "Frequently Asked Questions" ("FAQ") form that answered the question "What makes Next Century and PCO different from companies

In sum, we find that unlike the ownership interests in insurance policies in Life Partners, the PCO investment consisted of loans that investors made to PCO with the expectation of earning principal and interest from a common enterprise depending upon the efforts of PCO. Consequently, the PCO investment not only qualified as a security under Reves, but also satisfied all three elements of the Howey test establishing its status as an investment contract and a security.[28]

Accordingly, because we find that the PCO investment was a security, and because the respondents admit that they sold the PCO securities without providing prior written notice to US Life Equity, we affirm the Hearing Panel's finding that the respondents violated Rules 3040 and 2110[29] as alleged in the complaint.[30]

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in this business?" The FAQ replied that unlike other companies that make the investor "a partner in the policy," with PCO, the "[l]ender is never a partner in the policy." The FAQ also described that with other companies the "[i]nvestor's interest varies with [the] time of [the] seller's death," but with PCO "[e]ach lender is guaranteed a 25% interest per annum." Finally, PCO responded to the question "Why can't I be the beneficiary on the Policy?" as follows: "If you're tied to one single policy, you would be tied to that seller. If the seller exceeds life expectancy this could limit your pay off. PCO pays its Lenders from a fund of beneficiary proceeds from the pooled policies which ensures timely repayment of the loan."

[28] In addition, the respondents argue that the PCO notes were not securities because like the non-recourse notes created in Life Partners for IRA investments in viatical policies, the PCO notes did not change the "economic substance" of the transaction, which involved the underlying purchase of viatical insurance policies. We reject this argument and find that the "economic substance" of the PCO investment was a loan transaction that was evidenced by a note constituting a security.

[29] Conduct Rule 2110 provides that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." NASD Rule 115 states that persons associated with a member shall have the same obligations under the NASD's rules as members. Thus, the ethical standards imposed on members in Rule 2110 apply equally to persons associated with members.

[30] In addition, the respondents' argument that they relied on counsels' advice in determining that the PCO investment was not a security does not serve as a defense to the Rule 3040 violation. The defense is inapplicable when scienter is not an element of the violation, see Louis Feldman, Exchange Act Rel. No. 34933, at 5 (Nov. 3, 1994), and scienter is not required for a Rule 3040 violation. Moreover, their purported reliance on representations in the PCO materials that the PCO investment was not a security also does not excuse the Rule 3040 violation. A registered person cannot rely on an issuer's representation but must seek an official opinion by appropriate firm personnel. Frank W. Leonesio, 48 S.E.C. 544, 548 (1986) (registered representative may not rely on self-serving statements of an issuer); Gilbert M. Hair, 51 S.E.C. 374, 377 (1993) (registered

III. Sanctions

The Hearing Panel imposed sanctions against Fergus of an $8,000 fine and a 30-day suspension; against Devine of a $34,825.42 fine (a $25,000 fine and disgorgement of $9,825.42 in commissions) and a 45-day suspension; and against Blake of a $35,000 fine and a 90-day suspension. The Hearing Panel also ordered each respondent to requalify by examination as an investment company and variable contracts products representative. As discussed above, we called this case in part to review the sanctions imposed by the Hearing Panel and the Hearing Panel's analysis of the factors it considered mitigating and aggravating. We modify the Hearing Panel's findings of mitigating and aggravating factors, and we increase the sanctions imposed by the Hearing Panel.

A. Respondents' Arguments in Mitigation

The respondents argued before the Hearing Panel that the following factors should be considered mitigating: (1) the respondents' reliance on counsels' advice; (2) due diligence conducted by the respondents; (3) the respondents' subsequent efforts to assist their customers; (4) the respondents' lack of disciplinary history; (5) the fact that some of the customers were sophisticated investors; and (6) the respondents' contention that they acted in good faith; and (7) the lack of guidance provided by US Life Equity concerning the All American Bulletin. We address each of these in turn.

1. Advice of Counsel

The Hearing Panel rejected respondents' assertion that their reliance on counsels' advice regarding the security status of the PCO investment was mitigating. We agree, but we find that the Hearing Panel erroneously applied the test for the substantive defense of reliance on counsel's advice, rather than the Sanction Guidelines' test for determining appropriate sanctions based on a respondent's conduct.

The Hearing Panel stated: "To establish the defense of reliance on advice of counsel, a respondent must show that he: (1) made complete disclosure to counsel; (2) sought counsel's advice as to the legality of his conduct; (3) received advice that the conduct was legal and (4) relied in good faith on that advice." Although this test is appropriate in analyzing whether reliance on advice of counsel may serve as a substantive defense to a finding of violation,[31] this test is not controlling in analyzing whether reliance on counsel may mitigate

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representative's reliance on representation printed on the instrument stating that the instrument was not a security, rather than seeking the opinion by appropriate member firm personnel, was an insufficient basis for concluding that a transaction was not subject to Rule 3040).

[31] See e.g., William H. Gerhauser, Sr., Exchange Act Rel. No. 40639, at 12 n.26, 1998 SEC LEXIS 2402 at *24 n.26 (Nov. 4, 1998).

sanctions under the Sanction Guidelines. Under the Sanction Guidelines, the appropriate test is "[w]hether the respondent demonstrated reasonable reliance on competent legal or accounting advice." Under that standard, we find that the respondents' purported reliance on advice of counsel was not reasonable and was not a mitigating factor under the circumstances of this case.

We address the respondents' claim of mitigation in general, rather than as to each respondent, because the respondents assert that they shared with each other this purported advice, and also because we find that the advice did not meet the Guideline's competency and relevancy standards, primarily because reliance on informal advice given by interested or unqualified persons is objectively unreasonable. In weighing whether the purported reliance on counsel was reasonable, we note that no one single factor controlled our conclusion; rather we examined all the facts and circumstances of this case to determine whether the respondents reasonably relied on competent legal advice for purposes of assessing whether mitigation of sanctions is warranted.

We examine the respondents' assertion that their reliance on the following purported legal advice was mitigating: (1) The views of F.L., Blake's neighbor, regarding the PCO documents; (2) the J.R. legal opinion contained in the PCO materials; (3) G.S.'s assurances to Devine at the sales meeting that PCO was not a security; and (4) S.H.'s April 13, 1997 opinion letter, obtained from J.S., another agent and a friend of Devine's.

<u>i. F.L.'s Purported Advice.</u> The Hearing Panel found that Blake's purported reliance on F.L.'s views (<u>i.e.</u>, that F.L. had "no problem" with the PCO documents and that the J.R. legal opinion correctly stated the <u>Life Partners</u> holding) was not mitigating. We agree. Even if F.L. did inform Blake that the PCO materials correctly stated the holding in <u>Life Partners</u>, we find that this reliance did not constitute "reasonable reliance on competent legal . . . advice" under the Sanction Guidelines for several reasons. First, at the hearing, F.L. testified that he reviewed the PCO documents as a "potential investor," and he denied that he offered Blake legal advice.[32] Indeed, F.L. invested $85,000 in the PCO notes. Second, there is no evidence that Blake properly solicited F.L.'s advice within the context of an attorney-client relationship. Even assuming that Blake thought that F.L. was giving him legal advice

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[32] F.L. denied that he provided Blake with any legal advice. F.L. testified that Blake told him that the PCO investment was not a security because the PCO materials represented such. F.L. testified that he informed Blake that he had "no opinion about whether it was a security." F.L. testified that he read the J.R. legal opinion and the <u>Life Partners</u> decision "in the eyes of a potential investor" and that he had "doubts about the legal opinion" in part because it "seemed to be written by someone with a vested interest in the product." The Hearing Panel stated: "Although Attorney [F.L.] did voice some concerns to Respondent Blake about the [J.R.] legal opinion, Respondent Blake did not understand that Attorney [F.L.] had any serious reservations regarding the [J.R.] legal opinion." Nevertheless, for the reasons described above, we find that any reliance on F.L.'s advice would not have met the Sanction Guidelines' standards in mitigation of sanctions.

regarding the PCO investment, F.L. was not a securities lawyer and did not hold himself out as having expertise or competency in matters such as the application of the Life Partners decision to the PCO investment.[33] Moreover, Blake testified that he asked F.L. to "look over all the paperwork and see if [there were] any problems with it." Blake therefore did not request, nor obtain, F.L.'s advice on the specific issue at hand -- whether the PCO investment constituted a security such that notification to his firm would have been required under Rule 3040. Accordingly, we agree with the Hearing Panel's determination that respondents' purported reliance on F.L.'s advice is not a mitigating factor warranting a reduction in sanctions.[34]

ii. The J.R. Legal Opinion. The PCO marketing materials contained a December 4, 1996 opinion letter from J.R. addressed to the president of Next Century, Inc. ("Next Century"), PCO's marketing agent prior to MD Smith. The letter, however, specifically stated that it was not to be distributed without the consent of the firm. The letter stated: "The business of Life Partners is almost identical to the business arrangement between Next Century, Inc. and PCO . . . . Thus under the authority of the Life Partners case, there is no question and it is my opinion that the transaction as structured is not the sale of securities, and thus does not violate such law."

We find that any purported reliance on the J.R. legal opinion was not reasonable and is not mitigating. First, the J.R. legal opinion was not rendered in the context of an attorney-client relationship with any of the respondents. In addition, the opinion was provided as part of a marketing package by the issuer, PCO, and was addressed only to PCO's former

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33 F.L. testified that he had never done legal work for Blake, and that his employer prohibited him from providing legal advice outside of his employment. (F.L. was employed as a court administrator). F.L. testified that he had advised Blake of this prohibition on an earlier occasion when Blake had asked him to incorporate a business.

34 In addition, Blake testified that D.S. was one of the attorneys upon whose advice the respondents also relied. F.L. and Blake provided to D.S., a friend of F.L.'s who was an attorney practicing corporate law and estate planning and trust law, a copy of the PCO materials and the Life Partners decision. F.L. testified that D.S. informed him that the PCO investment appeared to be a security and had attributes of a "Ponzi scheme." F.L. testified that he informed Blake of D.S.'s remarks. In contrast, Blake testified that he asked F.L. whether D.S. had any problem with the PCO materials and that F.L. responded: "Not really."

To the extent the respondents purportedly relied on D.S.'s advice, we find that such reliance would not have satisfied the Sanction Guidelines' reasonableness and competency standards. None of the respondents actually had any conversations directly with D.S. Moreover, D.S. was not a securities lawyer. Finally, Blake testified that he was informed by F.L. that D.S. saw no "problem" with the PCO materials; the respondents therefore are not claiming that D.S. provided advice specifically on the question of whether the PCO investment was a security.

marketing firm and was not written for successor marketing firms or the public at large. Moreover, the opinion stated that it should not be distributed without the consent of the J.R. law firm, although there was no evidence that such consent had ever been obtained. Accordingly, we find that the respondents' reliance on the J.R. legal opinion did not constitute "reasonable reliance on competent legal . . . advice" to be considered mitigating under the Sanction Guidelines.

iii. G.S.'s Verbal Assurances. On February 22 and 23, 1997, Devine attended a self-described PCO "due diligence" meeting in Denver, Colorado. At the meeting, Devine met with Laing of PCO, Jenkins of Escrow Plus, Smith of MD Smith, and other individuals who had sold PCO notes. Devine testified that the question whether the PCO program was a security was raised repeatedly at the meeting. Devine testified that he specifically discussed whether the PCO notes were securities with G.S., a former prosecutor of the City of Denver and counsel for PCO. G.S. purportedly assured Devine that the PCO notes were insurance products and not securities.

The Hearing Panel concluded that the PCO meeting had the appearance of a "sales meeting" and that Devine should have recognized the repeated questions about the securities status of the PCO investment as a red flag and checked with his employer. We agree. We find that reliance on verbal assurances of issuer's counsel offered in the course of a sales meeting is not reasonable, particularly as to a question that has compliance implications for persons relying on such assertions. We therefore reject respondents' assertion that their reliance on G.S.'s purported legal advice was mitigating.

iv. The S.H. Letter. By letter dated March 31, 1997, S.H. provided a legal opinion addressed to J.S., who was a friend of Blake's and Devine's and a Michigan registered representative interested in selling PCO investments. The respondents maintain that S.H. was one of the attorneys upon whom they relied in determining that the PCO investment was not a security. We find, as did the Hearing Panel, that any reliance on the S.H. letter was not reasonable and is not mitigating. First, such advice was not given in the context of an attorney-client relationship with the respondents. Moreover, as noted by the Hearing Panel, the letter was dated after the respondents began selling the PCO investment, and therefore any reliance upon it to excuse those earlier sales is impossible. In addition, the letter was addressed to J.S. and not to the respondents, and principally addressed the sale of PCO investments and usury law in Michigan. Finally, the opinion did not expressly state that the PCO investment was not a security, but rather described the holding of Life Partners, and then stated that the PCO investment was structured as "strictly a loan transaction." Accordingly, we find that any purported reliance on the S.H. letter is not mitigating under the standards set forth in the Sanction Guidelines.

2. Efforts to Investigate the PCO Program

Devine testified that he conducted a number of Internet searches for information concerning viatical settlements. In addition, he testified that he attended the self-described PCO "due diligence" meeting in Denver, whereupon he concluded that PCO was a legitimate company and that the PCO investments were not securities. The Hearing Panel found that Devine undertook "negligible due diligence" efforts that were not mitigating.

As discussed above, the Hearing Panel concluded that the PCO meeting in Denver had the appearance of a sales meeting and should not have been relied upon by Devine. The Hearing Panel also noted that Devine's efforts did not include contacting the State Insurance Commissioner, although Devine claimed the PCO notes were insurance-related products. Accordingly, the Hearing Panel determined that Devine's efforts were "minimal." We agree that they were both minimal and ineffectual and do not, in the circumstances of this case, mitigate sanctions. A registered representative's prior investigation does not mitigate a breach of the fundamental duty to provide prior written notification to and obtain prior written approval from the employing member firm before participating in an outside securities transaction. We therefore reject respondents' argument that their efforts to investigate the PCO investment were mitigating.

3. Respondents' Conduct after Discovery of the PCO Fraud

Devine discovered that PCO principals had been indicted after reading an article on the Internet on April 7, 1997. He then contacted an attorney with the California Department of Corporations, who asked that he send a letter indicating amounts clients had invested in PCO in order to help the State freeze Laing's assets in Nevada and California. On about April 8, 1997, Devine contacted Blake and Fergus. Upon learning of the PCO fraud, the respondents contacted their customers. Blake testified that he suggested that his customers stop payments to PCO, and he attempted to stop customers' IRA transfers. He testified that he was successful in some instances. In May 1997, the PCO receiver contacted the respondents via a global email describing the claim process. The respondents submitted the amounts their clients had invested to the PCO receiver and they assisted clients in filling out claims forms.

The Hearing Panel found that Devine's efforts to recover his clients' funds, although "commendable," were not "greatly mitigative." With respect to Blake, the Hearing Panel found that his efforts to recover client funds were not mitigating and that the "66 % recovery had less to do with his efforts than with happenstance." We disagree with the Hearing Panel on this question. We consider Devine's effort to contact the California Department of Corporations and to assist the Department in freezing Laing's assets to be a mitigating factor warranting somewhat lesser sanctions than we otherwise would have imposed. We find similarly mitigating each of the respondents' efforts to contact customers upon learning of the fraud and to assist customers in recovering their funds. The respondents undertook these efforts prior to any detection by the firm or NASD staff of the violations. We think such efforts, when voluntarily taken, should be encouraged by appropriate consideration with respect to sanctions.

4. Lack of Disciplinary History

Blake first became registered as an investment company and variable contracts products representative in 1974, and Devine and Fergus first became registered in 1990 and 1989, respectively. All three respondents have no prior disciplinary history. The Hearing Panel found Devine's lack of disciplinary history mitigating. The Hearing Panel noted that Fergus had no disciplinary history but did not expressly find that fact mitigating. The Hearing Panel found that Blake's lack of prior disciplinary history was not "an aggravating factor."

The respondents argue that a lack of disciplinary history is mitigating and cite NASD decisions stating such. In contrast, the Department of Enforcement cites our more recent decision in Department of Enforcement v. Mark S. Balbirer, Complaint No. C07980011, 1999 NASD Discip. LEXIS 29 (NAC Oct. 18, 1999) (citing DBCC v. Tammy S. Kwikkel-Elliott, Complaint No. C04960004, at 8 (NAC Jan. 16, 1998) (finding that respondent's lack of disciplinary history is not mitigating, particularly when respondent has not been registered very long)). In Balbirer, we reversed a Hearing Panel's finding that the lack of disciplinary history in that case was mitigating. We stated:

> While we concur that the existence of disciplinary history is an aggravating factor, we do not concur that the lack thereof is mitigating. Registered individuals are required as part of the terms of their admission to the securities industry to comply with the NASD's rules and observe high standards of conduct. We are not compelled to reward a respondent because he acted in the manner in which he agreed (and was required) to act when entering this industry as a registered person. Id. at 10-11.

We again find that, consistent with our decision in Balbirer, a respondent's lack of disciplinary history is not mitigating. The Sanction Guidelines properly require consideration of the "respondent's relevant disciplinary history" but do not specifically require consideration of a respondent's lack of disciplinary history. See NASD Sanction Guidelines (Principal Considerations in Determining Sanctions), at 8 (1998 ed.). The Sanction Guidelines define "relevant disciplinary history" to include "(a) past misconduct similar to that at issue; or (b) past misconduct that, while unrelated to the misconduct at issue, evidences prior disregard for regulatory requirements, investor protection or commercial integrity."[35] Accordingly, under the Sanction Guidelines, a lack of disciplinary history is not considered "relevant disciplinary

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[35] The Hearing Panel found that the respondents' lack of disciplinary history, and the fact that the respondents have not repeated the conduct since moving to another member firm, indicated that "future violations are unlikely." We agree and have considered this fact in assessing whether the respondents are likely to repeat the misconduct and to what extent the sanction should serve as a deterrent.

history" for purposes of assessing appropriate sanctions, and the respondents' lack of disciplinary history does not warrant a reduction in sanctions.

5. Sophistication of Customers

In determining appropriate sanctions, the Hearing Panel analyzed whether the respondents' customers were sophisticated. As to Devine, the Hearing Panel found mitigating the fact that Devine's five customers were sophisticated.[36] We disagree and find no mitigation here. We hold that, except in unusual circumstances, the level of customer sophistication is generally not a relevant factor when determining appropriate sanctions involving a violation based on a respondent's failure to provide his firm with notice of a private securities transaction. Accordingly, we reverse the Hearing Panel's determination in this regard.

6. The Respondents' Contention That They Acted in Good Faith

The respondents also argue that even if the above factors cannot be considered mitigating, the factors show that the respondents acted in good faith, which should warrant mitigation of sanctions based on the Principal Guideline consideration of "whether the respondent's misconduct was the result of an intentional act, recklessness, or negligence."

The Hearing Panel found that none of the respondents intended to mislead their customers, omit material information, or falsely answer questions on the firm's routine compliance questionnaire.[37] The Hearing Panel noted that Blake himself invested $133,674 in the PCO investment and a relative of Blake's invested $95,000. The Hearing Panel also found, however, that because Blake had been in the securities industry for more than 10 years, he "should have known that written notification to his employer of his desire to participate in the PCO transactions was the best defense." The Hearing Panel further stated that it was "concerned that Blake appeared to deliberately avoid seeking the advice of his employer." We affirm the Hearing Panel's findings, and we reject Blake's argument that he acted in good faith in mitigation of sanctions.[38]

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[36] The Hearing Panel noted that one of Devine's customers invested $450,000 in PCO notes and had a net worth of $4 million, and that two of his other customers had a net worth in excess of $2 million.

[37] The respondents filled out the compliance questionnaires before they became involved in PCO. The compliance questionnaire asked that respondents answer only three questions: "Are you engaged in or do you derive economic benefit from any business activities other than insurance or securities sales? (2) With which US Life Insurance subsidiary are you affiliated? (3) With which general agency are you affiliated?"

[38] The Hearing Panel also found that certain aggravating factors were present with respect to Blake. First, the Hearing Panel found aggravating the fact that Blake successfully solicited 10 of his customers prior to the time that F.L. purportedly informed him that the J.R.

We also reject Devine's and Fergus' "good faith" mitigation arguments. As to Devine, the Hearing Panel noted that like Blake, Devine "also appeared to avoid seeking the guidance of his employer" regarding the PCO investment. According to the Hearing Panel, the PCO "due diligence" meeting that Devine attended had the appearance of a "sales meeting" and "should not have been relied upon." The Hearing Panel also noted that because the PCO meeting repeatedly raised the question of whether the PCO investment was a security, "Devine should have recognized the repeated question as a red flag and checked with his employer."

With respect to Fergus, the Hearing Panel found that Fergus determined that the PCO investment was not a security based on "his confidence in, and conversations with, Respondent Blake and Respondent Devine." Consequently, the Hearing Panel found his actions "were also more than simple negligence." We accept these findings and reject Fergus and Devine's argument that the sanctions should be reduced because they acted in good faith.

The respondents had a fundamental duty to comply with Conduct Rule 3040 in all respects before commencing any sales activities with respect to an unapproved securities transaction. We agree with the Hearing Panel that red flags existed such that the respondents should have been on notice that they might be dealing with a security, particularly given that the state of the law was unsettled as to whether certain viatical settlement contracts products might be securities. We think the respondents were aware that there was substantial uncertainty about the status of the PCO investment. Moreover, the fact that the PCO investment was structured as a note should have alerted the respondents to the fact that it might be a security.

7. Lack of Guidance by US Life Equity Concerning the All American Bulletin

The respondents asserted that they were led to believe by their firm's insurance affiliate that viatical settlement investments were not securities. In January 1996, All American, the insurance subsidiary, issued the Bulletin described above, which stated that

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legal opinion was "fine," and prior to the time that Devine reported the outcome of the Denver meeting. Blake argues, however, that he did not send the customers' checks to PCO until after he had received F.L.'s comments and Devine's report about the Denver meeting. We set aside the Hearing Panel's finding that Blake's solicitation of customers prior to F.L.'s comments or Devine's report was an aggravating factor, because as discussed above, we do not consider the purported legal advice or due diligence as relevant here for purposes of assessing appropriate sanctions. In addition, the Hearing Panel found it aggravating that in at least five instances, Blake's customers invested retirement funds. We also set aside this finding because a suitability violation was not alleged in this case, and because suitability considerations generally are not relevant to assessing appropriate sanctions for selling away violations.

insurance agents of All American were not permitted to sell viatical contracts to insureds of All American or to make it appear as if All American were sponsoring sales of such products. The restrictions were prefaced, however, with the following: "As you and your producers are independent contractors, we would not dictate to you how to conduct your business, except as it affects our company." The Hearing Panel found that the Bulletin "may have led to some confusion" because it gave "the impression that [sales of] viatical settlements were permissible under certain circumstances."[39] The Hearing Panel noted that US Life Equity "did not issue a bulletin discussing viatical settlements from the perspective of the securities firm to correct the misimpression of the All American Bulletin."

We agree that under the unique circumstances presented here, the respondents might have believed that they were not prohibited from selling viatical products, as long as they did so through their affiliations with other insurance carriers.[40] As independent contractors of US Life Equity and as non-exclusive insurance agents of All American, they were not required to report sales of insurance products to US Life Equity. The respondents testified that based on the All American Bulletin, they believed that they were permitted to sell viatical products as independent insurance contractors if they abided by the restrictions set forth in the Bulletin.

Although we note that the responsibility for compliance with all applicable securities laws and NASD rules rests with registered representatives, we find that the respondents' reliance on the Bulletin indicates that they may not have intended to act in contravention of the policies of their employer when they violated Rule 3040. Although we found as described above that there were red flags indicating that the PCO investment was a security, we recognize that based on the Bulletin, the respondents may have had a misguided belief that their sales in this instance involved only the insurance side of their businesses. We thus concur with the Hearing Panel's consideration of these unique circumstances as a factor in mitigation of sanctions as to all three respondents.

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[39] Hill, the US Life Equity compliance officer, testified that he believed that the Bulletin indicated that agents were not permitted to sell viatical settlement products under any circumstances.

[40] The respondents argue that the fact that they discussed viatical settlements with Link should be considered mitigating. However, the respondents did not specifically discuss with Link the PCO investment itself nor their intention to sell the PCO investment. Accordingly, we find that the respondents' discussions with Link were not "oral notice" and were not mitigating under the Sanction Guidelines. In addition, any purported "oral notice" to Link would not excuse the Rule 3040 violation because the rule requires written and detailed notice to the member firm, as well as prior written approval by the firm.

B. The Respondents' Rule 3040 Violations Were Serious

The supervisory process embodied in Conduct Rule 3040 plays a critical role in assuring investor protection, but it is not triggered until an associated person notifies his firm in writing that he wishes to engage in a private securities transaction. This written notice gives a member firm the opportunity to evaluate the transaction and to determine whether it will approve the transaction, and if it does, how it will supervise the associated person's participation in the transaction. This evaluation process is not only critically important for the protection of potential investors, but also for the protection of the member firm which will have responsibility for the transaction as if it were executed on its own behalf. Member firms cannot discharge these responsibilities unless they are informed of their associated person's wish to participate in a private securities transaction.[41] The rule is devitalized if each associated person decides for himself, based solely upon his personal evaluation of the proposed transaction, whether it is of a type that triggers the rule's notice requirement. The fact that both the notice and approval elements of the rule require a writing indicate that the relevant information about the transaction should be sufficiently specific and detailed to enable the member firm to make an informed decision about participation in the transaction and the appropriate supervisory controls for such participation.

Having considered all approprioprate evidence in mitigation, we find that an increase in the suspensions imposed below is necessary to impress upon respondents the importance of strict adherence to Rule 3040's requirements. The harm to the public in this case was extensive and entirely avoidable. We think the red flags described above were many and largely ignored. Respondents' registrations as both insurance and securities representatives required that they exercise care in ensuring that they complied with all applicable regulatory requirements.

We therefore increase Blake's suspension to 180 days. Blake's sanction is the most stern of the three respondents because he not only introduced the other respondents to PCO, he also sold the most to the most customers. His sales involved 20 customers who invested a total of $1.7 million. For his efforts, Blake received commissions of $14,450. In addition, we

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41 The Commission, in Anthony J. Amato, 45 S.E.C. 282, 285 (1973), has explained the importance of Rule 3040 as follows:

> Where employees effect transactions . . . outside of the normal channels and without disclosure to the employer, the public is deprived of the protection which it is entitled to expect . . . [S]uch conduct is not only potentially harmful to public investors, but inconsistent with the obligation of the employee to serve his employer faithfully [and the] employer's interest may be adversely affected. At the least, the employer should be enabled to make that determination.

find the fact that he sold PCO notes to five US Life Equity customers to be an aggravating factor also warranting an increase in his sanctions.

We affirm the Hearing Panel's imposition of a $35,000 fine on Blake. We have considered Blake's argument that he is unable to pay the fine, and we have reviewed his Statement of Financial Condition. We find that he has not demonstrated that he would be unable to pay the fine, and we note that he may seek to pay the fine under the NASD's installment payment plan. Finally, we affirm the Hearing Panel's requirement that Blake requalify as an investment company and variable contracts products representative.

With respect to Devine, we increase the suspension imposed by the Hearing Panel from 45 days to 90 days. We think a significant suspension is warranted here because of the gravity of the violations and the significant investment of customer funds. Devine solicited five customers who invested $898,479, for which he received $19,661.92 in commissions. (We note that Devine has paid $9,836.50 to the PCO receiver.) We affirm the fine of $34,825.42 and requalification requirement imposed by the Hearing Panel.

With respect to Fergus, we increase the suspension from 30 to 60 days. Fergus' three customers also invested substantial sums totaling $132,950.15. Although Fergus did not receive a commission on the sales, this occurred apparently only because the PCO fraud was discovered before his commission check was issued. In addition, we affirm the fine of $8,000 and the requalification requirement imposed by the Hearing Panel.[42]

We emphasize that we view a violation of the prohibition against private securities transactions to be a serious breach of a representative's duty to his member firm and to the investing public. Although the Sanction Guidelines permit us to impose suspensions of up to two years and bars in appropriate cases, we have determined to impose only limited suspensions under the unique circumstances of this case. In particular, we credit in mitigation the respondents' efforts to obtain a return of their customers' funds after discovering the fraud, prior to any detection of their wrongdoing by regulators. In addition, we have considered and concur with the Hearing Panel's finding that the respondents are unlikely to repeat the misconduct herein.

IV. Conclusion

Accordingly, we order Fergus to pay an $8,000 fine, we suspend him for 60 calendar days from associating with a member firm in any capacity, and we require that he requalify

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[42] The recommended sanctions are consistent with the applicable NASD Sanction Guidelines ("Guidelines"). See NASD Sanction Guidelines (1998 ed.) at 15 (Private Securities Transactions)). We reject respondents' argument that the sanctions imposed below were unfair and excessive because others have received lesser sanctions for Rule 3040 violations. See, e.g., Stephen J. Gluckman, Exchange Act Rel. No. 41628, at 8 (July 20, 1999).

by examination as an investment company and variable contracts products representative prior to acting in any capacity requiring that registration. We order Devine to pay a $34,825.42 fine, we suspend him for 90 calendar days from associating with a member firm in any capacity, and we require that he requalify by examination as an investment company and variable contracts products representative prior to acting in any capacity requiring that registration. We order Blake to pay a $35,000 fine, we suspend him from associating with a member firm in any capacity for 180 calendar days, and we require that he requalify by examination as an investment company and variable contracts products representative prior to acting in any capacity requiring that registration. The respondents are also ordered each to pay one-third of the $4,242.85 hearing costs below, or $1,414.28 each. The respondents are required to cease association with a member firm until such time as they have successfully requalified by examination.[43]

On Behalf of the National Adjudicatory Council,

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Jeffrey S. Holik, Vice President and
Acting General Counsel

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[43] We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

Pursuant to NASD Procedural Rule 8320, any member who fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will summarily be revoked.