NEW HAMPSHIRE

Department of Justice

Office of the Attorney General

Report of the Attorney General
to the Governor and Executive Council

Financial Resources Mortgage, Inc.

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I. INTRODUCTION

Accountability and responsibility are values that civilized people expect of each other and obligations that all reputable organizations readily embrace, especially good governments. State agencies have no less an obligation to the citizens they serve than those citizens have to each other. In the FRM matter, the Department of Justice, the Securities Bureau and the Banking Department to varying degrees share responsibility for the state's failure to detect and protect against the fraud inflicted on its citizens by Scott Farah and Donald Dodge. In this case, the lapses have been highlighted by the efforts of some not only to refuse to accept responsibility but also to pass off that responsibility to others.

The Governor and Executive Council have requested the Attorney General to evaluate and report on the operation of state government regarding its oversight and regulation of Financial Resources Mortgage, Inc. ("FRM").[1] The goal of this report is to provide the facts that will allow the Governor, Executive Councilors, legislators and citizens of New Hampshire to reach their own conclusions on how state government functioned regarding FRM's activities in New Hampshire. This Report includes detailed factual descriptions of state agency actions, and findings on how state agencies performed. In addition, this Report makes recommendations on how State agencies and the legislature can improve service to our citizens.

In the case of Ponzi schemes, regulators and enforcement agencies, working together, must assemble small pieces of a puzzle in order to see the greater picture. Unfortunately, regulators may be looking at pieces of different puzzles or different pieces of the same puzzle. Only with a great deal of cooperation can the various pieces available to each agency be sorted, combined, evaluated and pieced together. In this case, the pieces were not identified as pieces of the same puzzle and the agencies did not cooperate to create a complete picture of a Ponzi scheme before it collapsed on its own.

Furthermore, State regulators will not typically receive information that a Ponzi scheme is ongoing. Red flags, however, should trigger greater suspicion and critical review by regulators. When a company maintains poor control over its records, is not cooperative, provides misinformation, and otherwise demonstrates a lack of appropriate care in its business activities, regulators should consider whether the business can perform its obligations under the law. The failure of a financial company to keep its own financial records in order, for example, should trigger regulatory suspicion. Regulators should conduct an audit of the books of a company that has clearly violated its regulations. Simply relying upon assurances from the company that the regulator has all the relevant documents is inadequate.

The failure to share information and coordinate actions, failure to act on available information, failure to exercise regulatory curiosity, inadequate supervision of staff, limitations on agency jurisdiction and limited staffing all contributed to the State's failure in this matter.

[1] In 2009, the business was known as Financial Resources Mortgage, Inc. Prior to its close, it also operated under the names Financial Resources & Assistance of the Lakes Region, Inc., Financial Resources Mortgage, LLC, and Financial Resources National, Inc. For convenience, all variations of the company name are referred to as Financial Resources Mortgage, Inc. or FRM.

II. EXECUTIVE SUMMARY

A. Summary of Factual Background

FRM operated a residential and commercial mortgage brokerage and lending business in Meredith, New Hampshire.[2] Residential loans comprised a small percentage of the business. FRM was owned by Scott D. Farah. C L and M, Inc. ("CLM") purported to be a commercial loan servicer owned by Donald E. Dodge.[3] Both businesses closed their doors in November 2009. Gary Coyne worked closely with FRM on several enterprises, and was the beneficiary of several trusts created through FRM. Coyne also maintained his principal office at the address of FRM, used the letterhead and office equipment of FRM, and acted with the apparent or actual authority of Farah and FRM.[4]

Since at least 2005, FRM and CLM are alleged to have operated a Ponzi scheme that defrauded at least $20 million from at least 150 investors.[5] The operation and subsequent closure of FRM and CLM have had a substantial and long lasting impact on the investors who, in many cases, lost their life savings.

On March 9, 2000, the New Hampshire Secretary of State, Bureau of Securities Regulation ("Securities Bureau") received a complaint against FRM. The complainant, Attorney Steven Latici who had filed a lawsuit against FRM in federal district court on behalf of an FRM investor alleging securities violations, told the Securities Bureau that Scott Farah, FRM and Gary Coyne "...have engaged in a pattern of behavior designed to confuse [my client] as to the financial risk involved, the security for her investment, and the financial depth of the entity standing behind her investment." On April 4, 2000, the attorney wrote the Securities Bureau "[r]egarding your suspicion that the manner in which Financial Resources conducted business may constitute a so-called 'ponzi' scheme, I think the fact that Financial Resources failed to segregate the funds of its investors would clearly indicate that, in fact, they were operating a Ponzi scheme." On July 21, 2000, he wrote: "Based upon our review of the checkbook register provided by Scott Farah and, based upon his deposition testimony, it seems quite clear to me that Scott Farah and Financial Resources used investment funds deposited with them by other investors to pay obligations of Financial Resources to earlier investors."

Sixteen months after receiving the complaint, the Securities Bureau initiated an administrative proceeding against FRM on November 5, 2001. The Securities Bureau conducted discovery and a limited investigation, engaged in settlement negotiations, and held a hearing on July 24, 2003, twenty months after receiving Attorney Latici's complaint. The hearing was conducted before an unsupervised Securities Bureau hearing officer. Despite a statutory obligation to issue a ruling within a reasonable time, the hearing officer never issued an order following that hearing. The hearing officer decided not to issue an order because he determined

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[2] Secretary of State filings, https://www.sos.nh.gov/corporate/soskb/Filings.asp?369175.
[3] Secretary of State filings, http://www.sos.nh.gov/imaging/9923153.pdf.
[4] Gary Coyne Consent Order, Securities Bureau, Docket 00-007, Exhibit 1.
[5] Complaint, *Securities and Exchange Commission v. Scott D. Farah et al*, U.S. District Court, District of New Hampshire, filed March 9, 2010 ("SEC Complaint"), Exhibit 2.

that the investors of FRM would be better off if FRM offered to redeem their investments over time rather than be subject to an order that it offer all investors fully funded rescission as required by statute. In 2005 and 2006, the Bureau received notice of other violations. The Bureau performed a limited investigation, and in January 2007, settled with FRM for restitution to 35 investors.[6]

FRM has been licensed by the New Hampshire Banking Department since 1999.[7] All referrals for enforcement from the examination unit were funneled to a single, inadequately supervised staff attorney in the Consumer Credit Division. The Banking Department performed examinations of FRM in 2001, 2003, 2004, 2006, 2007, 2008 and 2009, many of which showed significant and repeated violations of state and federal laws, and several of which showed that FRM was conducting business in disregard of basic business, financial, governance and operational principles including an absence of appropriate policies, procedures and controls. The 2004 and 2006 examinations both prompted referrals for enforcement to the Banking Department's legal unit.

On December 16, 2005, the Staff Attorney for the Consumer Credit Division filed a Statement of Allegations.[8] The Statement of Allegations included three counts: failure to implement a program to safeguard consumers' sensitive financial information; failure to have a written safeguard plan; and failure to facilitate an examination. The Statement alleged good cause to revoke FRM's New Hampshire mortgage lending license, and that revocation was in the public interest as FRM "and Mr. Farah have illustrated a willingness to forgo the laws and rules of the State of New Hampshire whenever they see fit."

No hearing was ever held, no settlement was ever reached, and the Banking Department closed the matter in 2007 with no finding. It was only after the business shut its doors in 2009 that FRM's license was revoked.

Peter Hildreth has been both the Director of the Securities Bureau and Commissioner of the Banking Department. As Director, he was informed that his brother was an investor with Gary Coyne. Peter Hildreth said he should have no involvement with the matter. As Banking Commissioner, Mr. Hildreth again was informed that, during an examination of FRM, his brother was identified as an investor in the company. As he did at the Securities Division, he informed the individual who informed him that he should be recused from the matter. At no time were the files marked at either the Banking Department or Securities Division to document his recusal, nor was there another mechanism for flagging the file for Mr. Hildreth's conflict. There is no document in any file that reflects Mr. Hildreth's recusal.

On April 27, 2006, Mr. Hildreth instructed his staff to inquire if Securities wanted to conduct a joint examination of FRM with the Banking Department. On April 27, 2006, the Staff Attorney wrote memos directed to Commissioner Hildreth's attention regarding the number of complaints that had been filed against FRM, and the status of the administrative action pending

[6] Settlement documents, Exhibits 3 and 4. Prior to the 2007 settlement, FRM had begun to pay off shareholders in response to the Securities Bureau's action.
[7] Banking Department Examination Reports, Exhibit 5.
[8] Exhibit19.

against FRM. In 2006, Commissioner Hildreth participated in the FRM matter contrary to his recusal from it. No evidence, however, was discovered to indicate that he directed his staff to take a particular action during any examination of FRM, or interfered with the administrative enforcement action taken by the Banking Department.

The Department of Justice ("DOJ"), Consumer Protection and Antitrust Bureau ("Consumer Bureau") received five complaints against FRM between 2003 and 2008. All five complaints were referred to the Banking Department due to an exemption in the Consumer Protection Act for entities regulated by Banking and Securities. In June 2003, DOJ received a request from the Securities Bureau to take action to freeze the assets of FRM, and decided not to take any action. At that time, the NH Securities Act did not authorize the Attorney General to freeze assets, and the Securities Bureau's hearing was scheduled to occur only a month later. At least three individuals contacted the Criminal Bureau alleging criminal activity at FRM, and no action was taken. Within the DOJ, information about the various complaints was not shared or readily available in a central database, so that no one person was aware of the contacts made to three different bureaus.

A pivotal moment occurred on April 27, 2006 when the Banking Department informed the Securities Bureau that Banking was planning an unannounced examination of FRM. Banking suggested to the Securities Bureau that both agencies conduct a joint examination of FRM. By way of reply voice mail on May 4, 2006, the Securities Bureau responded that it would go separately. That decision by the Securities Bureau to go it alone allowed FRM to avoid scrutiny by the broad joint investigatory authority held by both agencies. Indeed, the Banking Department did conduct its examination, but the Securities Bureau did not conduct a thorough investigation of FRM. Instead, the Securities Bureau met with Farah, asked for some information, which he provided, and conducted little additional investigation. Shortly thereafter, the Securities Bureau entered into a Consent Agreement with FRM to resolve its administrative proceeding.

One of the primary functions of state government is to protect its citizens. Ferreting out Ponzi schemes and other fraud is hard. It is that very difficult nature that should lead, not to finger pointing and accusations, but to substantive review, informed decision making, improved cooperation, and a renewed effort to perform at a higher level on behalf of New Hampshire citizens.

B. Summary of Findings

This report documents the findings and conclusions of the Office of the Attorney General regarding the operation of the three agencies.

The following findings are made with regard to the Securities Bureau:

1. The Securities Bureau failed to conduct an audit sufficient to discover the fraudulent nature of FRM's business operations. The Securities Bureau received information in 2000 that FRM (1) was potentially operating a Ponzi scheme and (2) was commingling loan proceeds of an investor with funds in its operating account. It obtained in 2000 a copy of the investor's federal

court complaint, documents showing the misapplication of investor funds, and deposition transcripts. That information alone should have impelled a higher level of regulatory curiosity into the sources and uses of borrowed funds.

2. The Securities Bureau failed to adequately supervise its hearing officer. The appropriate role of a supervisor would have been to (a) know a hearing was held; (b) know no order had been issued and (c) ensure an order was issued. This oversight simply did not exist, and as a result, no order was ever issued after the July 24, 2003 administrative hearing.

3. The Securities Bureau failed to cooperate with the Banking Department. In 2006, the Securities Bureau decided not to participate with the Banking Department on a joint audit. A joint effort could have combined the resources of two agencies with different authority over the regulated entities FRM and CLM. The failure of the Securities Bureau to take advantage of the potential beneficial effects of a joint examination was an opportunity lost that could very well have exposed the true nature of FRM's operation.

4. The Securities Bureau failed to track funds used to fund the rescission. Had it done so, and accurately traced the funding source, the commingled nature of FRM's funds and scheme of paying one investor with funds from the next investor would likely have become apparent.

5. Professor Joseph C. Long's opinion, which was obtained by the Securities Bureau, is not relevant to the issue of whether or not the Securities Bureau had or should have had substantial, credible evidence available to it based upon which the Securities Bureau could reasonably have alleged that one or more of the FRM transactions potentially violated the NH Securities Act. The Securities Bureau, however, by seeking his opinion, has potentially narrowed its jurisdiction unnecessarily.

The following findings are made regarding the Banking Department:

1. The Banking Department failed in its mission to ensure that FRM complied with sound financial management and compliance with state and federal laws and regulations.

2. The Banking Department enforcement action against FRM was deficient. By 2004, the Banking Department recognized that FRM was operating in violation of state and federal laws and regulations. The Banking Department initiated a limited enforcement action against FRM, but thereafter failed to perform its role as regulator and supervisor of the licensee.

3. The Commissioner failed to implement and follow a policy of recusal. The Commissioner acknowledged that, when he learned that his brother was an investor in FRM, he should have no involvement with the file. Although Commissioner Hildreth asserted recusal from FRM, the files indicate that he participated in the matter in 2006. Commissioner Hildreth does not recall the circumstances surrounding conversations that occurred or memos issued to his attention in April 2006, and the former Staff Attorney involved at the time declined to speak to DOJ for this review.

The following findings are made with regard to the Department of Justice:

1. DOJ failed to adequately communicate with the Securities Bureau in writing of the reasons for not filing a superior court action, and thus failed in its agency counseling obligations.

2. DOJ failed to disseminate information within the agency. There was information in the Civil Bureau that FRM was subject to a Securities Bureau action. That information was not recorded in any database or other document that was accessible to any other lawyer or investigator at DOJ. DOJ received information from an attorney that a financial crime may have been committed by FRM. There is no record of any follow up or other action taken with regard to the report, and the Civil Bureau's knowledge of the Securities Bureau action was not available to the investigator. A pair of investors also contacted DOJ directly and spoke with someone in the office on two occasions. There is no record within DOJ of those calls, nor is there information regarding how the information received was handled.

3. DOJ failed to coordinate and cooperate with other agencies. Consumer complaints received by DOJ were referred to the Banking Department, but there was no follow-up with the Banking Department to determine the outcome of Banking's investigations. Timely and meaningful information sharing is necessary for decisions to be made based on all the information. Information on FRM was accumulated on a statewide basis, but not shared among agencies. DOJ is responsible for providing advice and legal representation in civil matters for all executive branch agencies and investigating and prosecuting major crimes. DOJ should take a leadership role to facilitate information and data sharing among related regulatory agencies and DOJ. As is described below in Section X of this Report, a regulatory working group should be formed, and one of the first tasks of the group should be to develop a system of information sharing among agencies.

4. DOJ failed to provide assistance to the Securities Bureau to correct a failed administrative hearing process. On September 12, 2006, the Securities Bureau informed DOJ that the Bureau's hearing officer had failed to issue an order in two cases, including the FRM case. The amount of time that had passed since the FRM hearing in 2003 may have made resurrecting the process untenable, DOJ has an agency counseling role that should have become involved. In that agency counseling role, DOJ should have worked with the Securities Bureau to evaluate its processes, and installed a proper, functioning administrative hearings process for the Securities Bureau.

C. Summary of Recommendations

This Report makes the following recommendations in light of the findings and conclusions discussed below:

1. Modify the Exemptions to the Consumer Protection Act.
2. Establish Consumer Protection Regulatory Working Groups Among Similar Regulating Agencies.
3. Require Full Time Hearing Officers.
4. Clarify the Exception within Securities Law to Allow Regulation of Investments in Trust Notes Secured by Real Estate.

5. Establish a Financial Services Unit Within DOJ.
6. Establish Written Recusal Policies.
7. Require Separate Legal Entities For Different Regulatory Oversight.
8. Mandate a Regulatory Disclosure Form.
9. Establish Statewide Centralized Business Lookup Function.
10. Add a Securities Lawyer Position at DOJ.

III. METHODOLOGY

In response to a request for a report from Governor Lynch and the Executive Council, Attorney General Delaney assigned Associate Attorney General Richard Head and Assistant Attorney General Christopher Marshall to gather facts, obtain documents and interview relevant witnesses. This Report is the result of that investigation.

A. <u>Documents Reviewed</u>

DOJ asked Banking and Securities to make available all documents related to FRM. Both cooperated with this request, and DOJ scanned all documents made available by the agencies. DOJ performed an internal search, and identified and scanned all DOJ documents related to FRM. The law firm of Nutter McClennen & Fish, LLP in Boston was also hired to give legal advice on this inquiry.

B. <u>Interviews Conducted</u>

Interviews were conducted of the following individuals:

- Mark Connolly, Securities Director
- Jeffrey Spill, Deputy Director, Securities Bureau
- Barry Glennon, Securities Bureau Hearing Officer/Deputy Director
- Kevin Moquin, Securities Bureau Staff Attorney
- Steven M. Latici, Attorney
- Christopher Lent, Former Securities Staff Attorney (by telephone)
- Mary Jurta, Director, Banking Department Consumer Credit Division, Formerly Director of Securities Filing at the Securities Bureau
- Peter Hildreth, Banking Commissioner, Former Securities Director
- Lorry D. Cloutier, Banking Department examiner
- Kerry R. Molin, Banking Department examiner
- Kim Griffin, Senior Banking Department examiner
- Donna Soucy, Former Banking Department General Counsel
- James Shepard, Former Staff Attorney, Banking Department
- Kelly A. Ayotte, Former Attorney General
- Peter Heed, Former Attorney General
- Michael A. Delaney, Attorney General, former Deputy Attorney General
- Bud Fitch, Deputy Attorney General
- Suzanne Gorman, Senior Assistant Attorney General
- Robert Carey, Former Assistant Attorney General

- Michael Bahan, Former investigator, DOJ
- Simon Brown, Former Senior Assistant Attorney General
- Ann Larney, Former Associate Attorney General
- Christopher Carter, Partner, Hinkley Allen & Snyder
- 7 investors

Steven Notinger, Trustee in the bankruptcy proceeding, provided additional information regarding the allegations contained in his complaint. Andrea Shaw, a former Staff Attorney with the Banking Department, declined to be interviewed.

C. DOJ Conflict Analysis

Shortly after the Governor and Executive Council requested this evaluation, concerns arose as to whether the Attorney General could perform an impartial review of this matter in light of DOJ's prior involvement with FRM. Specifically, the concern was focused on a request in 2003 from the Securities Bureau to DOJ to file an action in superior court to freeze assets of FRM. In response, and prior to commencing work, Attorney General Delaney contacted Secretary of State William Gardner and requested the Department of State to participate in conducting a joint conflicts evaluation to determine whether DOJ could conduct a fair, unbiased and open evaluation of the facts and events relating to FRM. General Delaney and Secretary Gardner each assigned one member of their office to conduct the preliminary conflicts evaluation. After conducting their examination, Senior Assistant Attorney General Boffetti and Deputy Secretary of State David Scanlan concluded that the Attorney General's Office could conduct an impartial review, and the Attorney General was uniquely authorized to conduct the review under RSA 7:8.[9] A copy of their report is attached as Appendix A.

D. Authors of this Report

Attorney General Michael Delaney began working with the DOJ in 1999 in the Criminal Bureau. He served as Chief of the Homicide Unit until 2004 when he became Deputy Attorney General. From 2006 to August 2009, he served as the legal counsel to the Office of the Governor. The Governor and Executive Council appointed him to serve as Attorney General in 2009.

Associate Attorney General Richard Head is the Director of the Division of Legal Counsel at DOJ. He began working with DOJ in 2001 in the Environmental Bureau. He was Bureau Chief of the Consumer Protection Bureau from September 2004 to December 2007, and was Acting Bureau Chief of the Consumer Bureau for the calendar year 2009. As is documented in this Report, five complaints were received by the Consumer Bureau between 2003 and 2008. Two of those complaints were filed while Attorney Head was Bureau Chief of the Consumer Bureau. All of those complaints were filed after the legislature amended the Consumer

[9] RSA 7:8 provides: "[The Attorney General] shall, when requested, advise any state board, commission, agent or officer as to questions of law relating to the performance of their official duties, and he shall, under the direction of the governor and council, exercise a general supervision over the state departments, commissions, boards, bureaus, and officers, to the end that they perform their duties according to law."

Protection Act, RSA 358-A, to exclude from the Act all "trade or commerce that is subject to the jurisdiction of the bank commissioner and the director of securities regulation, the insurance commissioner, the public utilities commission, the financial institutions and insurance regulators of other states, or federal banking or securities regulators who possess the authority to regulate unfair or deceptive trade practices." RSA 358-A:3. Thus, through an administrative process within the Consumer Bureau, all complaints that appeared to involve activities within the jurisdiction of the Banking Department were referred to Banking. The complaints against FRM were all handled in this manner, and required no input from Attorney Head. In his current capacity as Director of the Division of Legal Counsel, he has a supervisory role over the Civil Bureau. The interactions of lawyers within the Civil Bureau and Securities Bureau outlined in this report all occurred before Attorney Head became the Division Director.

Assistant Attorney General Christopher Marshall is assigned to the Civil Bureau. He is primarily assigned to advise the Department of Insurance Commissioner in his capacity as Liquidator of The Home Insurance Company. He has no supervisory role within the DOJ.

E. Limitations

This Report is being issued at a point in time when there are pending criminal investigations. It was beyond the scope of this Report to collect all documents seized by federal authorities from FRM and CLM. Records held by the FBI and U.S. Attorney's Office are unavailable for purposes of this review until criminal proceedings have concluded. Rather our assignment was to review the role of State agencies as regulators.

This Report is appropriately critical of the performance of State agencies in allowing FRM to continue to operate with inadequate regulatory oversight. It is reviewed in isolation, without context of the day to day workloads, except as otherwise referenced in the Report. Readers should be cautious in using the facts and findings in this Report as a measure of the overall performance of the individual staff outside of the context of this case. Performance can only be measured against the totality of their assignments, the priorities assigned to them by their leaders, and the volume and nature of all other work that must be conducted at an equally high level of performance. These facts should be viewed in conjunction with the many successes that each of the agencies have achieved, and recognize the hard work that is performed to achieve those successes. It is beyond the scope of this Report to evaluate the other work that was being performed simultaneously with the events described herein. Thus, this Report should not be read as condemnation of the performance of any individual staff that do not hold leadership responsibilities. Instead, the findings of this Report document substantial missed opportunities by State agencies regarding the operation and conduct of FRM and CLM.

This Report discusses the involvement of the respective agencies from 2000 through early 2009. It does not discuss investigations or events occurring in 2009, the year FRM and CLM failed. Without question, additional investor harm occurred in 2009, but the most significant agency involvement occurred from 2000 through 2008.

IV. ALLEGATIONS AGAINST FRM AND CLM[10]

Scott D. Farah, Donald Dodge and two others formed FRM in 1989 "to assist clients in obtaining capital for business and personal use."[11] FRM operated as a mortgage brokerage company. Farah's primary duties at FRM involved soliciting investors to fund construction and other loans. Around 1995, Farah became the sole owner of FRM, subject to the interest of preferred shareholders whose interests were more akin to those of note holders than of equity holders. Donald E. Dodge, was the director, president, secretary, and treasurer of CLM, FRM's loan servicer. He also served as a principal of Dodge Financial, Inc. ("Dodge Financial"), a New Hampshire corporation that served as trustee for numerous trusts organized by FRM to hold interests in real estate in connection with the Ponzi scheme. Donald Dodge also owned and operated Greatland Project Development, Corp. ("Greatland Development"), a New Hampshire corporation involved in various transactions in connection with the Ponzi scheme, including granting and holding numerous mortgages, despite having no other assets, or any income other than funds provided to it by CLM.

Greatland Development was formed ostensibly to coordinate multiple lenders for a single loan.[12] "[W]hen we had one or two or three people, we would use Greatland [Development] to close and then Greatland [Development] would issue two or three assignments so that all three persons were in first [priority]." At the time of closing on the loan, simultaneous closings would occur, with the first between Greatland Development and the borrower, and then Greatland Development would assign the mortgage to the lenders for the amount of the investment. As the number of investors for a particular project expanded, Dodge suggested creating real estate trusts. The investors became beneficiaries of the real estate trusts created by Dodge, with Dodge Financial as the trustee. Over one hundred trusts were ultimately created in this manner.

In 2005, Dodge formed CLM to service all loans brokered by FRM. Dodge and CLM were responsible for, among other things, maintaining funds provided by investors to fund specific loans, disbursing funds to borrowers, and making interest payments to investors.

From at least 2005, Farah and FRM solicited investors to invest in loans to fund commercial real estate projects and other businesses. Farah and FRM solicited investors, by among other methods, mailing postcards to persons whose names appeared on a targeted mailing list of previous private mortgage lenders purchased from a commercial database company. The postcards lured investors by promising high-interest returns to private mortgage lenders.

When a prospect indicated an interest in being a private mortgage lender, Farah added the prospect's name to FRM's list of prospective lenders. Approximately every other week, Farah and FRM would mail all prospective lenders a two to five page summary of each approved borrower's request for funding. If interested in investing in a particular loan, prospective lenders would call Farah to request the full underwriting file. Typically, if a prospective lender decided to invest in the loan, the prospective lender would, at Farah's request, send the funds required for that particular loan to CLM by wire or postal mail.

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[10] Unless otherwise indicated, the information in this section is derived from the SEC Complaint, Exhibit 2.

[11] Secretary of State corporation filings, http://www.sos.nh.gov/imaging/10707103.pdf.

[12] Information in this paragraph from interview Donald E. Dodge, 2/19/10, *In re Scott D. Farah and Financial Resources Mortgage,* U.S. Bankruptcy Court, District of New Hampshire ("Dodge Interview"), Exhibit 6.

For approximately the first two years of operations, CLM had one account at Citizens Bank dedicated to servicing loans structured by FRM, and in which Dodge and CLM deposited all investor funds. At or around the end of its second year of operation, CLM opened a second loan servicing account at Citizens Bank. Thereafter, to assist in the account reconciliation process, Dodge and CLM alternated between the two servicing accounts every three months, using just one servicing account exclusively while allowing time for transactions in the other servicing account to clear. Dodge and CLM did not at any time segregate funds in the servicing accounts by individual investor or borrower. Any time an investor sent money to CLM to fund a particular project, the funds went into one of the two servicing accounts.

FRM structured many loans that were set up so that the holder of the note and mortgage was a trust, on which Dodge Financial was trustee. They used the trust structure so that more than one investor could fund a particular loan and yet all retain the first position as creditors, which among other things, made it easier for Farah to attract investors and thereby raise more funds. When the loan was structured through a trust, the trust was the first position creditor, and each investor owned a beneficial interest in the trust proportionate to his, her, or its contribution to the loan. Farah and Dodge achieved a similar result through "simultaneous closings" whereby Dodge's company, Greatland Development, was the holder of the note and mortgage and, at the closing of the loan transaction, simultaneously issued two or more assignments to the investors who had funded the loan, so that each investor held a first position *pari passu* (or in common) with the other investors.

Farah and Dodge created trusts to close on loans whether or not investors had been lined up prior to closing.[13] A discretionary line of credit was established between Dodge and Farah they called SDLN (Scott and David Loan) to initially fund the closing. Farah would tell Dodge he had

> came across a loan and a borrower who wanted funding, good credit, just a prime borrower, and he knew he had lenders, lots of them that would vie for that loan. In order to facilitate a closing quickly and not losing that borrower, he would call for – an SDLN.

Funds from investors who subsequently loaned money for that closing after the fact were commingled in the CLM bank account. The debt associated with the SDLN "discretionary line of credit" was not, however, taken off of CLM's books.

Farah represented to prospective and actual investors that an investor's funds would be used to fund only the specific loan that the investor agreed to fund, and for no other purpose. Farah did not disclose to prospective and actual investors that, in fact, all investor funds were pooled together into the CLM servicing accounts from which the Farah and Dodge routinely withdrew funds for, among other things, funding other loans, paying returns to other investors, paying personal expenses and paying operating expenses of FRM and CLM, including Farah's and Dodge's salaries. Numerous investors who invested funds through FRM and CLM received

[13] Information from this paragraph is from Dodge Interview at 77-83; 94-96, Exhibit 6.

no recorded interest in a mortgage or other title to an asset of value as a result of their investments.[14]

With respect to many of the loans, Farah told investors that there was a prepaid interest component. In these instances, Farah represented to investors that CLM would withhold one year's worth of interest (or some other amount depending on the term of the loan) from the borrower and reserve the funds in an escrow account from which to pay interest to the investor for one year (or other specified period). Instead, CLM pooled the prepaid interest in one of the general CLM servicing accounts at Citizens Bank and did not in any instance hold the reserve funds in a separate account for the particular loan for which it was reserved or for any particular investor.

Many of the loans structured by FRM were purportedly for construction. In a construction loan, only a portion of the total loan amount was disbursed to the borrower at closing. FRM represented to investors that the remainder of the principal and any prepaid interest component were to be held in an account maintained by CLM and disbursed over time as the construction progressed in response to requisitions periodically submitted by the borrower. CLM maintained those funds in the commingled general servicing accounts at Citizens Bank.

Farah represented to investors that the borrower would pay, and the investor would receive, interest on the entire principal from the date of investment, even on loan requests that had not yet been fully funded, and construction loans that had been only partially disbursed to the borrower. In fact, in these instances, CLM, FRM, or some combination thereof, used investor money to make interest payments to investors.

Farah often encouraged investors to "rollover" principal funds towards a new loan, and thereby frequently avoided returning principal to investors. Farah and Dodge used other investors' funds from the CLM servicing accounts to pay "interest" to investors for the period between the payoff of the former loan and the closing of the new loan.

In June 2005, Farah, on his own behalf, as borrower, and Dodge, on behalf of CLM, as lender, signed a Discretionary Line of Credit Agreement. The Discretionary Line of Credit Agreement had an original ceiling of $4 million that was later increased to $10 million. Pursuant to the Discretionary Line of Credit Agreement, CLM transferred money from one of its loan servicing accounts maintained at Citizens Bank to one of FRM's accounts at Citizens Bank, or to some third party specified by Farah.

From June 2005 to November 2009, Farah drew off this line of credit, exceeding the $10 million ceiling and misappropriating for his own use, and for the use of FRM, a total of at least $20,348,321 of investor funds. Neither Farah nor Dodge disclosed to any prospective or actual investor that CLM had entered into a Discretionary Line of Credit, nor that investor monies had been and would continue to be used to fund the Discretionary Line of Credit.

[14] Complaint by the Bankruptcy Trustee, ¶11, *In Re: Financial Resources Mortgage, Inc. et al.*, U.S. Bankruptcy Court, Case Nos. 09-14565-JMD and 09-14566-JMD ("Trustee Complaint"), Exhibit 7.

Farah stated that "two or three million" dollars of the line of credit was necessary to pay off some preferred shareholders in FRM.[15] The remainder of the funds from the line of credit was used to "keep the business going and trying to do different things to earn the funds to pay it back."[16] The funds for the line of credit came from construction funds held by CLM prior to being disbursed to borrowers.[17] As described by Dodge,

> Let's say we got $300,000 in from a lender and the closing only required $50,000 or $150,000, the balance of the funds to be used for the construction would sit in [CLM's bank account] depending on how fast the borrower worked his project.[18]

Prior to taking out the line of credit from CLM, FRM operated in much the same way. "[E]ssentially we were doing the same thing on a much smaller scale where somebody was borrowing – doing a hundred thousand dollar construction loan and [FRM] would use whatever was not being used for the construction."[19] Farah's use of its construction funds to cover FRM's deficits occurred well before 2005.[20]

The investors in FRM were hardworking citizens, and many were not experienced financial investors. One investor told DOJ that he had worked his entire life working in construction and dry walling. Over the years, he had purchased apartments and other real estate, and owned them mortgage-free. Those properties represented his life's savings, and were to provide for him and his family in retirement. He was persuaded by Scott Farah to mortgage those properties in order to obtain cash, which was then invested through FRM. When FRM crashed, he lost all the money he invested, and has begun to lose his mortgaged real estate by foreclosure as he has been unable to pay his loans.

From October 2005 through October 2009, FRM and CLM allegedly transferred to Center Harbor Christian Church at least $382,150. Scott Farah's father, Robert Farah, was the Pastor of the Center Harbor Christian Church.[21]

V. PONZI SCHEMES DEFINED[22]

A Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, the operators focus on attracting new

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[15] Interview Scott D. Farah, 2/18/10, *In re Scott D. Farah and Financial Resources Mortgage*, U.S. Bankruptcy Court, District of New Hampshire ("Farah Interview"), Exhibit 8. Although not explicitly linked in the interview, some of this "line of credit" was likely used to pay the shareholders who were the subject of an administrative action taken by the Securities Bureau. According to Farah, the preferred shareholders "would get a check back for their preferred shares and then they would turn around and those funds would go back to [CLM] to fund a particular loan." Farah Interview at 71.
[16] Farah Interview at 72, Exhibit 8.
[17] Dodge Interview at 59, Exhibit 6.
[18] Dodge Interview at 60, Exhibit 6.
[19] Farah Interview at 75, Exhibit 8.
[20] Farah Interview at 77, Exhibit 8.
[21] Trustee Complaint, Exhibit 7.
[22] U.S. Securities and Exchange Commission, http://www.sec.gov/answers/ponzi.htm.

money to make promised payments to earlier-stage investors and to pay personal expenses, instead of engaging in any legitimate investment activity.

Ponzi schemes are named after Charles Ponzi, who duped thousands of New England residents into investing in a postage stamp speculation scheme in the 1920s. At a time when the annual interest rate for bank accounts was five percent, Ponzi promised investors that he could provide a 50% return in just 90 days. Ponzi initially bought a small number of international mail coupons in support of his scheme, but quickly switched to using incoming funds to pay off earlier investors.

With little or no legitimate earnings, the schemes require a consistent flow of money from new investors. Ponzi schemes tend to collapse when it becomes difficult to recruit new investors or when a large number of investors ask to cash out.

Many Ponzi schemes share common characteristics. Signs of a Ponzi scheme include:

- High investment returns with claims of little or no risk. Every investment carries some degree of risk, and investments yielding higher returns typically involve greater risk.
- Overly consistent returns. Valid investments tend to go up and down over time, especially those seeking high returns.
- Unregistered investments. Ponzi schemes typically involve investments that have not been registered with state and federal securities regulators. Registration is important because it provides investors with access to key information about the company's management, products, services, and finances.
- Unlicensed sellers. Federal and state securities laws require investment professionals and their firms to be licensed or registered. Most Ponzi schemes involve unlicensed individuals or unregistered firms.
- Secretive and/or complex strategies. Investments often are difficult to understand and complete information is not available.
- Difficulty receiving payments. Ponzi scheme operators sometimes encourage participants to "roll over" promised payments by offering even higher investment returns.

VI. SECURITIES BUREAU

A. Analysis of Securities Bureau Jurisdiction

Any person or entity who issues or proposes to issue any security (collectively, "issuers") must register with the Securities Bureau. Securities must be registered before they are sold, unless the particular security or transaction is exempt from registration under the NH Securities Act. The Securities Bureau also licenses and regulates "broker-dealers," who receive compensation in connection with the sale of a security. It also investigates complaints of fraud under the NH Securities Act,[23] including fraud in connection with securities or transactions that may have qualified for an exemption from registration with the Securities Bureau.

To determine whether any person has violated the NH Securities Act , the Securities Bureau has a diverse array of investigatory tools available to it. For example, the Director of the Securities Bureau, may

- Make such investigations within or without New Hampshire as he deems necessary;
- Require any person to file a statement in writing, under oath as to all the facts and circumstances concerning the matter being investigated;
- Require an issuer, broker-dealer, or agent to report to the Securities Bureau all transactions as they pertain to any security; and
- Administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence and require the production of any books, papers, correspondence, memoranda, agreements, or other documents or records which he deems relevant or material to the inquiry.[24]

The threshold question for any inquiry by the Securities Bureau is whether the matter potentially involves an act or omission in connection with a "security" that may have violated the NH Securities Act. In relevant part, [25] the NH Securities Act defines a security as follows:

> [U]nless the context otherwise requires…, any note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit sharing agreement; membership interest in a limited liability company; partnership interest in a registered limited liability partnership; partnership interest in a limited partnership; collateral trust certificate; preorganization certificate or subscription; transferable shares; investment contract; … certificate of deposit for a security; … or, in general, any interest or instrument commonly known as a security, or any certificate of interest or participation in, temporary or interim certificate for, receipt for guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

(Emphasis added.)

Broadly speaking, the activities of Farah, FRM, Dodge or CLM involved four categories of lending transactions, each of which is summarized below, again taking at face value the description of the lending transactions that Farah provided to investors:[26]

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[23] The NH Securities Act broadly proscribes manipulative, deceptive or otherwise fraudulent conduct in connection with the securities. See RSA 421-B:5 ("It is unlawful for any person to effect any transaction in, or to induce the purchase or sale of any security by means of any manipulative, deceptive or otherwise fraudulent device or contrivance, including any fictitious quotation.").

[24] RSA 421-B:22.

[25] RSA 421-B:2 (introductory clause and paragraph XX).

[26] These categories described what Farah claimed was occurring. These categories are complicated by the additional layer of fraud committed when Farah and Dodge commingled all the investor's and borrower's funds were commingled in a single bank account and used for a variety of uses. No moneys were escrowed or otherwise segregated.

1. **Category A –** A person (an "investor") solicited by Farah would loan money to a borrower identified by Farah and in exchange the investor would receive from the borrower a promissory note secured by a mortgage on residential or commercial real estate.
2. **Category B –** Two or more persons (the "investors") solicited by Farah would loan money indirectly to a borrower identified by Farah by providing funds to Dodge's company Greatland Development, which would act as nominee for the investors. Greatland Development then would transfer the money to the borrower and in exchange Greatland Development would receive from the borrower a promissory note secured by a mortgage, typically on commercial real estate (or a residential real estate development project). Greatland Development then would assign an equal interest in the promissory note (and the underlying mortgage) to each investor. CLM or another entity controlled by Dodge would act as "loan servicer."[27]
3. **Category C –** Two or more investors solicited by Farah would loan money indirectly to a borrower identified by Farah by providing funds to a trust formed by Dodge. The trust then would transfer the money to the borrower and in exchange the trust would receive from the borrower a promissory note secured by a mortgage, typically on commercial real estate (or a residential real estate development project). Dodge Financial or another entity controlled by Dodge would act as loan servicer. The trust would not assign an interest in the promissory note (and the underlying mortgage) to the investors; instead, the investors would have an indirect interest in the promissory note through an ownership interest in the trust.
4. **Category D –** Dodge would form a trust to close on a loan to a borrower identified by Farah before Farah would receive commitments from investors to fund such loan. On an interim basis, an entity controlled by Dodge would loan the funds to the trust. The trust then would transfer the money to the borrower and in exchange the trust would receive from the borrower a promissory note secured by a mortgage, typically on commercial real estate (or a residential real estate development project). CLM or another entity controlled by Dodge would act as loan servicer. Subsequently Farah would receive commitments from investors to fund a take-out of the Dodge bridge loan by providing money to the trust (or a Dodge-controlled entity) in exchange for an ownership interest in the trust. The trust would not assign an interest in the promissory note (and the underlying mortgage) to the investors; instead, the investors would have an indirect interest in the promissory note through the trust.[28]

There <u>potentially</u> would have been at least three different types of "securities" in the transactions summarized above, again taking at face value the description of the lending transactions that Farah provided to investors:

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[27] A loan servicer is an entity that typically monitors, collects, and remits loan payments, monitors property tax and insurance escrows, provides notification of late payments, and forecloses on defaulted loans.

[28] Information from this paragraph is from Dodge Interview at 77-83; 94-96, Exhibit 6.

1. The "note" or "promissory note" (or "other evidence of indebtedness") issued by the borrowers (Categories A, B, C and D).
2. The ownership interest in the trusts formed by Dodge. (Categories C and D).
3. An "investment contract" resulting from the series of interconnected transactions orchestrated by Dodge and Farah. (Categories B, C and D).

Attached as Appendix B is a detailed legal analysis of DOJ's conclusion that the promissory notes issued in the Farah and Dodge transactions were "securities" under the NH Securities Act.

B. Administrative Enforcement by the Securities Bureau

On March 9, 2000, Attorney Steven Latici, a lawyer representing an investor of FRM, wrote to the Securities Bureau. At that time, he wrote that Scott Farah, FRM and Gary Coyne,[29] "have engaged in a pattern of behavior designed to confuse [my client] as to the financial risk involved, the security for her investment, and the financial depth of the entity standing behind her investment." Mr. Latici had filed an action in the federal court on behalf of his client alleging securities violations and fraud by Farah, FRM and Coyne. On April 4, 2000, Attorney Latici wrote again to the Securities Bureau: "Regarding your suspicion that the manner in which Financial Resources conducted business may constitute a so-called "Ponzi" scheme, I think the fact that Financial Resources failed to segregate the funds of its investors would clearly indicate that, in fact, they were operating a Ponzi scheme." On July 21, 2000, he wrote: "Based upon our review of the checkbook register provided by Scott Farah and, based upon his deposition testimony, it seems quite clear to me that Scott Farah and Financial Resources used investment funds deposited with them by other investors to pay obligations of Financial Resources to earlier investors."[30] Mr. Latici was conducting discovery in the federal action and forwarding documents to the Securities Bureau, including deposition transcripts of Farah and of Latici's client, check book registers, and the opinion of an expert that he had hired saying the notes at issue were securities under state law. The information provided by Attorney Latici made clear that Farah was using investor money to fund operations.

The Staff Attorney for the Securities Bureau at the time, Christopher Lent, chose not to take any action on the complaint. He said in an interview that several factors contributed to his decision. First, because the investor was already represented by a lawyer and a lawsuit had been filed, the investor would have her issues reviewed by a judge. Although it was not a formal policy of the Securities Bureau, it was his policy. No one else in the Securities Bureau was involved in his decision to take no action. He stated he was not generally supervised in his enforcement work. In addition, Attorney Lent indicated that his workload was sufficiently high that he could only take on a limited number of enforcement matters at any one time. At the time of the complaint filed by Attorney Latici, Attorney Lent said in an interview he was actively

[29] Gary Coyne was involved in several development enterprises and became the beneficiary of several trusts created through FRM. Farah Interview at 19-22, 26-27, 32. Coyne also maintained his principal office at the address of FRM, used the letter head and office equipment of FRM and acted with the apparent and or actual authority of Farah and FRA. Gary Coyne Consent Order, Securities Bureau, Docket 00-007, Exhibit 1.

[30] Attorney Spill has concluded that, based on his conversations with investors, there was no indication of widespread fraud or an ongoing Ponzi Scheme in 2000, nor was there evidence of it in 2003 when the Securities Bureau held its administrative hearing.

involved in an investigation of an employee of Merrill Lynch. That was a joint investigation with the SEC, and it took up a significant amount of his time.

Attorney Lent left the Securities Bureau in the summer of 2000. On October 16, 2000, Attorney Latici wrote to Peter Hildreth, who was at that time the Director of the Securities Bureau. Attorney Latici wrote that he believed the Securities Bureau intended to pursue an administrative action against FRM.[31] He said that the action was "to prevent [FRM] from engaging in this investment scheme wherein they would solicit investment funds from investors and then issue a promissory note in the name of the corporation." Mr. Hildreth has no current memory of receiving the letter, and he indicated it would be common for correspondence to be redirected before it ever hit his desk.

Attorney Latici's letter was delivered to Jeff Spill, who joined the Securities Bureau in December 2000. Unlike his predecessor, Attorney Spill decided to investigate the complaint. Attorney Spill began his investigation with a letter to Attorney Latici on December 28, 2000 requesting more information regarding the case. Mr. Latici responded with copies of his prior correspondence, note, assignments and depositions.

On April 18, 2001, Attorney Spill and Mary Jurta[32] met Gary Coyne in Meredith to examine notes that may be subject to the Securities Bureau's jurisdiction. When he began working with the Securities Bureau, Attorney Spill had no prior securities experience. He relied upon Ms. Jurta's experience during the meeting in Meredith. During the course of that meeting, Ms. Jurta saw two notes that involved Mr. Hildreth's brother. Upon returning to the office, Ms. Jurta informed Mr. Hildreth of the notes, and Mr. Hildreth informed her that he should not be involved in the case. That recusal is not documented at the Securities Bureau. No record or other information was discovered for this Report that indicated Mr. Hildreth had any involvement in the case while he was the Director of the Securities Bureau.

In response to a document request from the Securities Bureau, Farah claimed that he was unable to provide the Securities Bureau with his records due to confidentiality requirements in the Banking laws. In light of Mr. Farah's claim, Attorney Spill contacted the Banking Department. He first contacted Kimothy Griffin, an examiner with the Banking Department, on April 10, 2001. In the course of that conversation, Mr. Griffin provided Attorney Spill with information regarding the type of licenses held by FRM and some of the requirements. In addition, because Mr. Farah was claiming he could only give documents to the Banking Department, Attorney Spill contacted Blaise Heroux, then the Supervisor of Examiners of the Consumer Credit Division of the Banking Department, to seek assistance from Banking to obtain the documents. On May 8, 2001, Attorney Spill faxed a sample request for information to Mr. Heroux. Attorney Spill was, however, unable to obtain any records through the Banking Department.

Mr. Spill wrote to Farah on November 9, 2001 and stated that bank privacy laws did not apply to the documents he was requesting since he was requesting FRM's bank records and not

[31] This conclusion is contrary to Attorney Lent's recollection of his decision.
[32] Ms. Jurta was employed with the Securities Bureau at that time. She left the Securities Bureau in November 2002 to work for the Banking Department.

those of its customers, plus he was seeking information about the issuance of the promissory notes.

Peter Hildreth left the Securities Bureau in September 2001 to become the Commissioner of the Banking Department. Mark Connolly was his successor as Director of Securities.

On November 5, 2001, Attorney Spill initiated a Securities Bureau administrative action by filing a Staff Petition for Relief with the Director. Attorney Spill alleged that Gary Coyne, Scott Farah and FRM induced seventeen individuals to invest in unsecured promissory notes without being licensed by the Securities Bureau.[33] Attorney Spill sought a cease and desist order, administrative fines, suspension of licensing privileges and made requests for certain information. At the end of October, Mr. Latici settled the federal action on behalf of his client and later withdrew the complaint filed with the Securities Bureau.

On November 8, 2001, Robert Ambrose, Deputy Secretary of State, issued an administrative order against Farah, Coyne and FRM. The Order required that they cease and desist from violating the securities laws, produce certain documents, and show cause as to why the relief sought by Attorney Spill should not be granted.

Following the issuance of the Order, the case was stayed on numerous occasions by agreement while the parties exchanged discovery. Mr. Coyne reached a settlement with the Securities Bureau in October 2002. Under the agreement, Coyne was required to cease and desist from any further violations of the Securities Act and pay a $1000 administrative fine.[34]

By letter dated January 14, 2003, the Securities Bureau reached a tentative agreement (a/k/a the "undertaking") with Farah and FRM to stay the administrative proceedings contingent on FRM and Farah satisfying the requirements of the agreement.[35] Under the agreement, Farah and FRM would, among other things, undertake a rescission offer to the holders of its outstanding preferred stock and notes. To undertake a rescission offer, FRM needed to contact investors and offer to rescind the sale of the securities issued to the investors. The agreement required that the rescission offer be fully funded. It also provided that FRM would not issue any new "securities" without prior approval of the Bureau, but FRM could redeem or repurchase any outstanding preferred stock if requested by the holder. FRM agreed to provide, by April 14, 2003, audited financial statements for the periods ending December 31, 2001 and December 31, 2002. Any change in the identity of the auditor had to be approved by the Bureau. FRM also had to submit updated lists of shareholders and the amounts of their investments.

At that time, Attorney Spill did not believe a Ponzi scheme was in effect. Attorney Spill stated in an interview that after Attorney Latici's client settled her federal court litigation, he contacted other investors to identify one who would be willing to take a lead role at the administrative hearing. Attorney Spill defined a Ponzi scheme as one involving "widespread fraud." In his communications with the investors, he learned they were uniformly satisfied. If

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[33] The Staff Petition was also amended twice. The 1st amendment added another nine investors, and the 2nd amendment brought the total to thirty-five investors. See Exhibits 9, 10 and 11.

[34] Exhibit 1.

[35] Exhibit 12.

the investors "thought there were misrepresentations occurring, that was their time to say something." For the most part, he described the responses from investors as claiming "the State was spoiling their party." As a result of the lack of complaints and general satisfaction of the investors and the lack of evidence of widespread fraud, he concluded no Ponzi scheme was yet occurring.

Attorney Spill met with Farah's counsel on June 3, 2003 and reviewed information supplied pursuant to the undertaking, including financial statements, assets, disclosure of additional investors and Farah's proposal for a partially-funded and pro rata rescission offer.

On June 11, 2003, Attorney Spill met with Senior Assistant Attorney General Suzanne Gorman to discuss the status of the FRM administrative action. During the course of that meeting, they discussed Farah's desire to pay rescission on a pro rata basis, and the requirement under the Securities Act that only allows full rescission. They also discussed the possibility of initiating an action in Superior Court to freeze FRM's assets.[36] They discussed the process involved in going to superior court, and "the various hoops" that would need to be jumped through and the legal burden of proof. They discussed what assets existed (a house, the office building), some held in the name of FRM, some not. They also discussed the existence of accounts receivable. At the end of the conversation, although he said he was not expressly told, Attorney Spill understood that the Department of Justice would not be filing an action in superior court. As a result, in order to document his disagreement with that position, Attorney Spill wrote to DOJ on June 17, 2003:[37]

> This letter is a follow-up on our conversation on 6/12/2003. Thank you for spending the time assisting our office. Yesterday, 6/16/2003, the above named Respondents were notified that negotiations for settlement of the state's claims would terminate and the state will proceed to a hearing on 7/8/2003. The investors were also notified by letter of the same date that there will be a hearing to determine the outcome of the alleged violations of unregistered and unlicensed securities transactions and that we represent the state and not the investors. I will wait to hear from you regarding the issue of securing assets for the benefit of the investors. Our hearing date remains 7/8/2003.

Farah and FRM were unable to meet the contingencies of the agreement that the rescission offer be fully funded. By letter dated June 16, 2003, Attorney Spill advised counsel for Farah and FRM:

> The Bureau's position at this juncture is that the Respondents have been given sufficient time and they have been on sufficient notice that the Bureau's demand is and has always been for a fully funded rescission available through liquid

[36] Attorney Spill stated that the action he contemplated would be to freeze assets under the Securities Act. At the time, the Securities Act only authorized the Attorney General to obtain a temporary or permanent injunction, restraining order or writ of mandamus, not asset freeze. The Securities Act was amended, effective after the meeting on August 16, 2003, to allow the Attorney General or Secretary of State to seek an order for an asset freeze, accounting, attachment, or appointment of a receiver or conservator.

[37] Exhibit 13.

assets. The verbal proposals for resolution put forth by the Respondents to date are unsatisfactory. It is clear from the financial data submitted that the Respondent's asset base is illiquid and uncertain, and not readily transferable to fully fund a rescission offer.

On July 23, 2003, Barry Glennon, an attorney with the Securities Bureau, and the Hearing Officer on the FRM case, issued an Order denying FRM's Motion to Dismiss the proceeding. In his Order, Hearing Officer Glennon stated "[c]learly, this matter is factually intensive and a determination relative to whether the instruments promoted by the Respondent are securities requires a complete vetting through an administrative hearing." On the issue of full or partial rescission, Hearing Officer Glennon wrote: "Any decision to order full or partial rescission must be based on what is fair and equitable for all investors. Such a determination can not be made without learning more about the financial condition of the Respondent and the whereabouts of all monies."

In light of Attorney Spill's June 16, 2003 letter, and the July 23, 2003 Order denying FRM's Motion to Dismiss, the hearing commenced before the Hearing Officer on July 24, 2003, a year and a half after the Staff Petition was filed, and over three years after the first complaint was filed. By the time of the hearing, the Staff Petition had been amended twice, and rescission for a total of 35 investors was at issue. At the hearing, FRM argued the notes at issue were not securities and that FRM was entitled to take advantage of certain exemptions. To the extent the Hearing Officer did order rescission, FRM sought an order for partial rescission, while the Securities Bureau sought full restitution.

Hearing Officer Glennon stated in an interview that he understood he was required to issue a decision within thirty days of the hearing. The Securities Act requires "[w]ithin a reasonable time after the hearing, the presiding officer shall issue a written decision stating the action to be taken by the department and may set forth findings of fact, conclusions of law, and disposition. All decisions shall be reached upon the basis of a preponderance of the evidence. The decision of the presiding officer shall be construed as the decision of the secretary of state."[38] Following the 2003 hearing, however, Mr. Glennon did not issue a ruling. Mr. Glennon stated that his decision not to issue an order was based on the competing demands of the staff seeking full restitution, which he thought was impractical, and the demand of FRM for an order allowing payment over time, which he concluded was not authorized by statute. He also thought that payments in the ordinary course of business would ultimately result in what the Staff Petition sought, full payment to the investors. He believed there was sufficient income being generated by the business to pay the investors off within two years. He also concluded that an order of full restitution would push the company into bankruptcy. He said that if he ordered full restitution, it would trigger a trial de novo in the Superior Court and that would be another year out. He thought that holding off would be the best result under the circumstances in terms of the investors receiving a return of their investment. He concluded that by not issuing an order, investors would be paid in the ordinary course of business. Since his interpretation was "all or nothing for restitution," he decided not to issue an order. When asked what the downside was on appeal, Mr. Glennon stated that there would "be delay in finalizing and return of funds to investors," and "in two years [they would] get restitution anyway."

[38] RSA 421-B:26-a, XXI (Supp. 2009)

As a Hearing Officer, Attorney Glennon stated that he was not subject to any supervision. This was because the Hearing Officer was screened from the remainder of the Securities Bureau as it relates to matters subject to a hearing in order to avoid ex parte communications.

Attorney Spill, who had commenced the administrative action, likewise did not file any pleadings in the administrative action complaining about the Hearing Officer's failure to issue a ruling within a reasonable amount of time.

Approximately two and one half years later, on November 5, 2005, the Securities Bureau received a call from an investor being represented by Attorney Christopher Carter. The investor alleged that Farah solicited the investor's involvement in a non-existent company. On April 25, 2006, the Concord Monitor published an article describing the civil lawsuit filed by that same investor against Farah and his father, Robert Farah, the Pastor of the Center Harbor Christian Church.[39]

The Concord Monitor article also triggered renewed conversations between Attorney Spill and Attorney Maloney. In an interview, Attorney Spill reported that, since 2003, Farah had been paying restitution to the investors who were the subject of the Securities Bureau's administrative action. In 2003, at the time of the hearing, the total value of the rescission was more than $2 million. By 2006, the total value of the rescission was roughly $1.2 million. Attorneys Spill and Maloney were in regular contact, and Attorney Spill's impression was that there was no cause for alarm, and the company was not spiraling out of control.

On April 27, 2006, when the Banking Department was preparing to conduct an unannounced audit of FRM, Banking contacted the Securities Bureau to ask if they wanted to hold a joint examination with Banking. By way of reply voice mail on May 4, 2006, the Securities Bureau responded that they would go separately.[40] On May 4, 2006, Attorney Spill wrote to Attorney Maloney regarding the investors described in the Concord Monitor article, and requested a meeting at FRM. On May 19, 2006, Attorney Spill and a Securities Bureau auditor met with Farah and Attorney Maloney. On May 22, 2006, Attorney Spill followed up on the meeting to confirm his request for all "participation" agreements and related documentation, as well as a list of legal claims. After some back and forth correspondence between Attorneys Spill and Maloney, on September 21, 2006 Attorney Spill expressed his belief:

> that there are more 'participation notes' than was first represented during our audit of 5/19/2006.... Given that all of these notes were not actually secured mortgages, they are securities having no registration or exemption. Moreover, it appears that some of these notes were issued after the hearing held on 7/24/2003,

[39] Exhibit 14. *See also* Section VI (D), Banking Department Enforcement Action.

[40] On May 27, 2003, Attorney Spill sent an email to the Banking Department asking whether a copy of the examination report generated by Banking would be made available to him. He was advised as a preliminary matter that "the relevant statutes to look at are 397-A:12, 383:9, 383:10-b, all of which apply to our examinations of mortgage brokers and bankers. 383:10-b seems to be very clear as to the confidential nature of the exam and reports but doesn't specifically address other state agencies" Exhibit 15.

a time when Mr. Farah clearly would have or should have known that distribution of such notes would be in question.[41]

Attorney Spill concluded by suggesting a potential resolution to all the outstanding matters with Farah and FRM. On January 25, 2007, the Securities Bureau and FRM entered into a Consent Agreement, and the Securities Bureau took no further action.[42]

C. Findings

Finding #1: The Securities Bureau had enough information to conduct an investigation sufficient to discover the fraudulent nature of FRM's business operations. The Securities Bureau received information in 2000 that FRM (1) was potentially operating a Ponzi scheme and (2) was commingling loan proceeds of an investor with funds in its operating account. It obtained in 2000 a copy of the investor's federal court complaint, documents showing the misapplication of investor funds, and deposition transcripts. That information alone should have impelled a higher level of regulatory curiosity into the sources and uses of borrowed funds. As the Bureau acquired more information, the necessity for independent examination became more compelling, e.g.:

- FRM's financial statements showed that it was paying 12 % on its preferred stock, which was treated as a debt obligation, and as much as 25% on demand notes;
- FRM could not develop an accurate list of its stakeholders and its stakeholders included preferred stockholders, some of whose shares were issued without having been authorized, and demand note holders;
- FRM engaged in stock transactions after the Cease and Desist Order issued, which the Bureau knew about by 2006;
- FRM conceded it could not fund full restitution but argued that it should be allowed to earn its way out of its illegal stock issuances;
- The Securities Bureau received information in November 2005 and again in April 2006 of alleged investor fraud of a type that originally prompted its petition, performed a site visit in May 2006, and then relied on information supplied by FRM and its counsel to explain the allegations;
- BSR entered into a Consent Decree in 2007 without checking or having an independent party check the sources of funds for the rescission.

In essence, by 2006, the Securities Bureau learned that Farah had misrepresented the number of preferred shareholders that existed in 2003, and further engaged in further violations of the Securities Act after the 2003 hearing. A regulated business that lies to or misleads its regulator should be treated as highly suspect.

The Securities Act was amended in 2007 to authorize the Securities Bureau to audit those "licensed or required to be licensed under [the Securities Act]."[43] Prior to the 2007 amendment,

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[41] Letter from Jeff Spill to Denis Maloney, September 21, 2006, Exhibit 16.
[42] Consent Agreement, Exhibit 17, as amended on July 12, 2007, Exhibit 18.
[43] Effective July 1, 2007.

the Securities Act only authorized audits of *licensed* broker-dealers, investment advisers, or issuer-dealers. Those who were not licensed, however, were subject to extensive investigatory and subpoena authority. In essence, although the procedural mechanisms were different, the Bureau had audit authority by virtue of its authority to investigate violations of the Securities Act. RSA 421-B:22, II authorized the Securities Bureau to

> ...administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence and require the production of any books, papers, correspondence, memoranda, agreements, or other documents or records which the secretary of state deems relevant or material to the inquiry.

The Securities Bureau failed to take full advantage of its power to investigate, issue subpoenas, examine documents or take testimony as authorized under the Securities Act. In essence, while not called an audit, the investigation and subpoena authority of the Securities Act gave the Bureau the full authority to conduct the equivalent of an audit.

Although the Securities Bureau requested and reviewed some documents as part of the administrative investigation, it did not conduct a thorough audit of the books and records. Instead it relied on information supplied by FRM's auditor which, along with other information, should have prompted more examination. Contrary to FRM's assertions and contrary to the Bureau's conclusion based on FRM's assertions, FRM was not a "viable" business. A more aggressive assertion of its investigatory authority, would likely have detected the fraud before it collapsed on its own. The fundamental error by the Securities Bureau was that it failed to follow the money. It did not examine the source of funds used to pay borrowers and the use of funds from investors. The error occurred at the time of the initial investigation leading up to the hearing in 2003, again in 2006 after receiving information about additional violations, and again in 2007 by failing to monitor payments under the consent decree.

Once it had information that all of the investor and lender funds were being maintained in a single account, it would have been a relatively straightforward investigation to determine what information the investors were given about the nature of their investment. If, as was the case, the investors and lenders were informed that their investments were being used to fund a specific project, and payment would be generated from repayment of the loan related to that project, the fraudulent misrepresentation would likely have led the Bureau to discover the true nature of FRM's operation. [44]

It could also be argued that the Securities Bureau could not have known about the pooled investment scheme because FRM and CLM did not form Greatland Development (Category B) until 2004, and did not begin using the trust vehicles until later (Categories C and D). While that is correct, FRM had been pooling investor assets as early as 2000, which was pointed out to the

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[44] For example, in alleging the existence of a Ponzi scheme, the SEC has asserted that from "at least 2005, [Farah, FRM, Dodge, and CLM] did not segregate investor money and used investor money for a variety of purposes not authorized by the offering documents, including paying returns to earlier investors, paying personal expenses, paying operating expenses of FRM and CLM, including Defendants Farah's and Dodge's salaries, donating money to the Center Harbor Christian Church (a non-denominational church owned by Defendant Farah's father and of which Defendant Farah was the treasurer), and for personal investments in speculative businesses." *See* SEC Complaint, paragraph 2, Exhibit 2.

Securities Bureau by Attorney Latici. By 2001, the Bureau had initiated an enforcement action, but had not connected enough pieces of the puzzle to conclude that FRM was using a fraudulent pooled investment scheme.

Finding #2: The Securities Bureau failure to adequately supervise the hearing officer. The Securities Bureau took action in 2001. That action, however, was not triggered by an investigation of a Ponzi scheme or fraud, but arose out of transactions with thirty-five investors in unsecured notes. The Securities Bureau issued an administrative Cease and Desist Order. After a year and a half of continuances requested by FRM, a hearing was held on July 24, 2003. Notwithstanding the fact that the Hearing Officer had an obligation to issue a decision within a reasonable time after the hearing, he did not do so – he never issued a decision. In an interview, he stated that the issue of whether or not FRM was issuing securities was not in doubt, but the law only allowed full rescission. He felt that if he followed the law, the business would fail. As a result, he opted not to issue an order and thereby allow the business to continue to operate. He felt the evidence presented demonstrated the business had the financial ability to pay the investors in the ordinary course of business, and that was the preferred remedy.

In any legal proceeding, simply initiating an action does not result in any legally binding result. Similarly, simply holding a hearing has no binding effect. It is only by way of an order or executed settlement agreement that a decision can become binding, and the penalties and injunctions that are ordered become enforceable. If orders or agreements are never finalized, there are no consequences to prevent a company from simply committing additional violations. Simply initiating an action does not provide consumers with meaningful protection. The Hearing Officer failed to issue an order, and as a result, no enforceable decision was ever rendered.

The failure to issue a decision is a systemic failure of the Securities Bureau. The Bureau failed to adequately supervise its hearing officer. While supervisory issues are somewhat more complicated when a hearings officer is employed by the same office that employs the staff advocate, these issues are not uncommon in state government. The Securities Bureau took some measures to screen the hearing officer from the staff advocate, but failed to take any steps to provide the hearing officer with supervision.

The Supreme Court has described the appropriate role of a supervisor when a hearing officer is an administrative employee as follows:

> On issues of policy and legal interpretation, hearings examiners are subject to the direction of the agency by which they are employed, and their independence is accordingly qualified. Influence ordinarily is not deemed improper unless it is aimed at affecting the outcome of a particular proceeding. Thus, the assistant commissioner's efforts to ensure that the hearings examiners' decisions conformed to his interpretation of relevant law and policy were permissible so long as such efforts did not directly interfere with 'live' decisions.[45]

[45] *Asmussen v. Commissioner, New Hampshire Dept. of Safety*, 145 N.H. 578, 592 (2000) (internal quotations and citations omitted).

In a manner consistent with the *Asmussen* decision, the Securities Bureau should have established appropriate supervisory controls. Agencies that have employees who act as hearing officers must take steps to assure separate lines of supervision and communication for staff and hearing officers. Agency organization charts should explicitly document separate lines of supervision between hearing officers and staff advocates. Written standard operating procedures should be established to address maintaining firewalls between hearing officers and staff advocates. Electronic records should be stored in a manner so that the hearing officer cannot gain access to them.

While the agency may not direct a subordinate serving in a quasi-judicial role to reach a particular outcome in a case being heard by the subordinate, the agency may and should exercise an appropriate supervisory role to ensure that a decision is rendered. There was no institutional check on the Hearing Officer's failure to issue an order within the required a reasonable time. A supervisor would (a) know that a hearing was held; (b) know that no order had been issued and (c) ensure an order was issued. This oversight simply did not exist.

<u>Finding #3</u>: The Securities Bureau failed to cooperate with the Banking Department. In 2006, the Securities Bureau decided not to participate with the Banking Department on a joint audit. A joint effort could have combined the resources of two agencies with different authority over the regulated entities FRM and CLM. While it must be acknowledged that the Securities Bureau's audit provision would likely not have applied, it did have extensive investigatory authority. There was no effort to coordinate the Banking Department's examination with a Securities Bureau investigation. The Banking Department had reason to believe FRM was not in compliance with the Banking Department's laws, and the Securities Bureau had reason to believe FRM was not in compliance with the NH Securities Act. The failure of the Securities Bureau to take advantage of the potential beneficial effects of a joint examination was an opportunity lost that could very well have exposed the true nature of FRM's operation.

<u>Finding #4</u>: The Securities Bureau failed to track funds used to fund the rescission. In 2003, the Securities Bureau had concluded that FRM was insolvent. Nevertheless, FRM managed to provide restitution to shareholders to the extent of approximately $1 million between 2003 and 2006, and another $1 million in 2007. The dichotomy between insolvency and payment of $2 million is striking. It failed, however, to trigger any regulatory curiosity, and the Securities Bureau did not seek any information about the source of funds. Had it done so, and accurately traced the funding source, the commingled nature of FRM's funds and scheme of paying one investor with funds from the next investor would likely have become apparent.

<u>Finding #5</u>: Professor Joseph C. Long's opinion is not relevant to the issue of whether or not the Securities Bureau could reasonably have alleged that one or more of the FRM transactions potentially violated the NH Securities Act. The Securities Bureau, however, by seeking his opinion, has potentially narrowed its jurisdiction unnecessarily.

DOJ, with the assistance of Nutter McClennen & Fish, has reviewed the legal opinion that the Securities Bureau obtained last month from Joseph C. Long, Professor Emeritus at the University of Oklahoma College of Law,[46] in which Professor Long addressed in the abstract

[46] The opinion is dated April 21, 2010.

whether promissory notes issued in transactions similar to those summarized above as Category A (and arguably similar to those summarized above as Category B) would constitute securities for purposes of the NH Securities Act. Specifically, Professor Long addressed the following question: "Whether under the [NH Securities Act], promissory notes, coupled with a whole mortgage on tangible personal or real property, commercial or residential, are securities when the owner of the property originates the mortgage and promissory note and then sells them as a unit to a third party in the Initial primary sale?" Professor Long's conclusion is that under the current NH Securities Act a promissory note, coupled with a whole mortgage on tangible personal or real property, commercial or residential, never is a "security" within the meaning of the NH Securities Act, regardless of the circumstances, when the owner of the property originates the mortgage and promissory note and then sells them as a unit to a third party. Professor Long bases his conclusion entirely on text of the transactional exemption in RSA 421-B:17(II)(d), which exempts from the requirement to register with the Securities Bureau "any non-issuer sale of notes or bonds secured by a mortgage lien if the entire mortgage, together with all notes or bonds secured thereby, is sold to a single purchaser at a single sale" (emphasis added). Professor Long asserts that "The only way to harmonize the . . . [relevant] public policy goal and the actual language of the New Hampshire Act, in my opinion, is to treat the original sale [of a promissory note together with the underlying mortgage] as one not involving the sale of a security. Professor Long also observes that "This conclusion is not a sound decision from both a theoretical and academic perspective, but it is a practical way to accomplish the acknowledged public policy goals involved within the language of the New Hampshire Act."

Professor Long's legal conclusion is relevant only to, but hardly determinative of, the Category A and, arguably, the Category B transactions. Professor Long's opinion, however, does not address whether in the scenarios covered by Categories C and D – in which investors acquire an interest in a trust – an ownership interest in any of the trusts constitutes a security under the NH Securities Act. In addition, Professor Long does not address the issue of whether series of interconnected transactions orchestrated by Dodge and Farah constitutes an "investment contract and therefore a security for purposes of the NH Securities Act.

DOJ offers the following observations that should be considered:

- The drafters of the Uniform Securities Act upon which the NH Securities Act was based appear to have intended that the definition of a "security" would evolve to reflect the relevant interpretations under the Federal Securities Act.
- It is reasonable to assume that the drafters of the NH Securities Act, like the drafters of the 1985 Uniform Securities Act a few years later, were aware of the "family resemblance" test in the 1976 *Exchange National Bank of Chicago v. Touche Ross & Co.* (later endorsed by the Supreme Court in the 1990 *Reves* case) and expected the Securities Bureau (and the New Hampshire courts) to apply that family resemblance test in determining whether a promissory note is a security.
- The Securities Bureau should carefully consider whether relying on the Reves test (rather than the Professor Long's legal conclusion) would afford the Securities Bureau with a more appropriate degree of regulatory and enforcement discretion to protect investors in New Hampshire.

By seeking the opinion of an expert to narrow its jurisdiction in response to fears it would be seen as having failed in its mission, the Securities Bureau has acted in a manner detrimental to the investor community and potentially the Bureau. Because Professor Long has concluded that the narrow class of promissory notes discussed are not securities at all, the anti-fraud protections would not apply. Thus, a broker who fraudulently induces an elderly investor out of millions of dollars could avoid the Bureau's enforcement authority simply by securing the fraud with a commercial real estate mortgage. Such an outcome should not be advocated by the Securities Bureau.

VII. BANKING DEPARTMENT

A. Jurisdiction

FRM has been licensed by the New Hampshire Banking Department since 1999.[47] As it relates to FRM, the Banking Department has authority to regulate nondepository first mortgage bankers and brokers (RSA 397-A) and mortgage loan servicers (RSA 397-B).

Within its authority over mortgage bankers and brokers, the Banking Department regulates persons who engage in the business of offering, originating, making, funding, or brokering "mortgage loans" from the state of New Hampshire or mortgage loans secured by real property located in the state of New Hampshire. RSA 397-A:2. Taken together, the definitions of "mortgage loans," "real property" and "residential real estate" as defined in RSA 397-A:2, the Banking Department's jurisdiction regarding mortgages is limited to first or second mortgage loans on property to be used primarily for personal, family, or household use. The residential property cannot exceed 4 units if it involves multifamily residential property. Until 2009, the residential property had to be owner occupied in order to be subject to the Department's jurisdiction.

A mortgage loan servicer licensed under RSA 397-B can be an individual, partnership, corporation, association, or other entity which records payments on its books and records and performs such other administrative functions as may be necessary to properly carry out a mortgage holder's obligations under the mortgage agreement. This can include the receipt of funds from the mortgagor to be held in escrow for payment of real estate taxes and insurance premiums and the distribution of such funds to the taxing authority and insurance company. The meaning of mortgage loan is the same as under RSA 397-A. Therefore, the type of loan managed by a loan servicer within the Banking Department's jurisdiction is the same as the loans covered by RSA 397-A.

The Banking Department has exclusive authority and jurisdiction to investigate conduct that is or may be an unfair or deceptive act or practice or that may violate any of the provisions of RSA 397-A and RSA 397-B.[48]

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[47] Banking Department Examination Reports, Exhibit 5.
[48] RSA 383:10-d.

In 2009, significant changes were made to various banking laws in accordance with the federal SAFE Act. One of the changes resulting from those amendments relates to the Banking Department's jurisdiction over construction of residential housing. A significant number of loans associated with FRM involved construction loans. Prior to 2009, the definition of "Real Property" in RSA 397-A:1, XXI provided:

> Real Property means land and the improvements which are affixed thereon, including, but not limited to, single-family homes, multifamily dwellings not exceeding 4 units, manufactured housing as defined in RSA 384:16-d, II, and any single-family condominium unit, wholly or partly used or occupied, or intended to be used or occupied, as the home or residence of one or more persons.

This definition was incorporated into RSA 397-B through the definition of "first mortgage loan" in RSA 397-B:1.

RSA 397-A:2 described the application of the chapter, in part, as:

> I. This chapter shall provide for the department's regulation of persons that engage in the business of making or brokering mortgage loans secured by real property located in the state of New Hampshire, which is or shall be occupied in whole or in part as a place of residence by the borrower and which consists of not more than 4 living units.

In 2009,[49] with the passage of the SAFE Act provisions, the definition of "Real Property" was changed to:

> Real Property means a dwelling or land and the improvements which are affixed thereon or are intended to be fixed thereon, including, but not limited to, single-family homes and multifamily dwellings not exceeding 4 units, wholly or partly used or occupied, or intended to be used or occupied, as the home or residence of one or more persons.

RSA 397-A:2 was changed to read:

> I. This chapter shall provide for the department's regulation of persons that engage in the business of offering, originating, making, funding, or brokering mortgage loans from the state of New Hampshire or mortgage loans secured by real property located in the state of New Hampshire.

These changes removed the requirement that the dwelling be owner occupied. Furthermore, prior to 2009, the language was changed from "land and the improvements which are affixed thereon..." to "a dwelling ***or land*** and the improvements which are affixed thereon ***or are intended to be fixed thereon***...." With the change in 2009, the legislature expanded the Department's jurisdiction from previously constructed residential dwellings to include loans for the construction of dwellings.

[49] Effective July 31, 2009.

That same definition provides the limitation on the Banking Department's jurisdiction to single-family homes and multifamily dwellings not exceeding 4 units. Prior to the 2009 legislation, the scope was narrower and limited to owner occupied dwellings.

Over the last eight years, the banking statutes have been amended by the legislature with regard to the confidentiality of documents obtained by the Department. Those changes include the following:

> 2002 – At that time, all Banking Department examination and investigation information was privileged. The Department could not share examinations or investigations of banks or other institutions it regulated with other agencies. The law did authorize release, as it does today, if, in the judgment of the commissioner, the ends of justice and the public advantage will be served by the publication of the confidential documents. The law also authorized the Banking Department to furnish confidential information to the federal supervisory authorities and to certain independent insuring funds. State investigatory agencies were not included at that time.
>
> 2003 – HB 817 added language to the examination section of the mortgage statute including a provision for the confidentiality of examination reports.[50]
>
> 2005 - SB 223 added examination and information sharing ability with other regulators in New Hampshire with other regulators in this state pursuant to information sharing agreements.[51]
>
> 2008 - HB 759 clarified the information sharing authorized by SB 223 in 2005 to make explicit the ability of the Banking Department to share examination information with regulators other than mortgage regulators.[52]
>
> 2009 - HB 610 enacted all the provisions of the Federal SAFE Act including stronger examination requirements. With regard to information sharing, the bill authorized the commissioner to enter agreements or sharing arrangements with other governmental agencies, the Conference of State Bank Supervisors, the American Association of

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[50] "All reports pursuant to this section shall be absolutely privileged and although filed in the department as provided in paragraph IX shall nevertheless not be for public inspection. The comments and recommendations of the examiner shall also be deemed confidential information and shall not be available for public inspection."

[51] "In adopting rules, preparing forms, setting standards, and in performing examinations, investigations, and other regulatory functions authorized by the provisions of this chapter, the commissioner may cooperate, and share information pursuant to confidentiality agreements, with regulators in this state and with regulators in other states and with federal regulators in order to implement the policy of this chapter in an efficient and effective manner and to achieve maximum uniformity in the form and content of applications, reports, and requirements for mortgage bankers and brokers, where practicable."

[52] "The commissioner may, in his or her discretion, accept all or a part of a report of examination of a mortgage banker or mortgage broker, certified to by the regulatory supervisory official of another state. To avoid unnecessary duplication of examinations ***and investigations***, the commissioner, insofar as he or she deems it practicable in administering this section, may cooperate ***and share information*** with the regulators of ***this state and*** other states, the Federal Trade Commission, the Department of Housing and Urban Development, other federal regulators, or their successors in conducting examinations and investigations." Language in bold italics was added by the bill.

Residential Mortgage Regulators, or other associations representing governmental agencies regarding information on the Nationwide Mortgage Licensing System and Registry. It also made explicit that the Banking Department could share information with law enforcement agencies for the purposes of criminal investigations.

B. Examinations[53]

The Banking Department is divided into Consumer Credit and Banking divisions. The Consumer Credit Division licenses and supervises nonbank mortgage lenders and brokers, second mortgage lenders, small loan companies, sales finance companies, retail sellers, debt adjusters and mortgage loan servicers. All of the activities relevant to FRM occurred within the Consumer Credit Division of the Banking Department.

Shortly after Peter Hildreth became Commissioner of Banking in September 2001, he promoted Kimothy Griffin to Supervisor of Examiners. Commissioner Hildreth directed Mr. Griffin to improve the nature and quality of examinations performed by the Consumer Credit Division. An examination of most institutions licensed by the Banking Department must be conducted every 18 months.[54] Prior to Commissioner Hildreth's appointment, the Banking Department considered a review of an application for licensing or renewal license to be sufficient to satisfy the obligation to perform an examination. Commissioner Hildreth required that examinations be on-premises examinations.

The Banking Department's interactions with FRM occurred primarily in the context of license renewal and examinations. Examinations of FRM were performed in 2001, 2003, 2004, 2006, 2007, 2008 and 2009.

The initial examination of FRM occurred in 2001. The examiner was Kimothy Griffin. He reported, among other things:

- The Company does not properly disclose the yield-spread premium on the Good Faith Estimate in violation of RESPA (Real Estate Settlement Procedures Act).
- The loan files reviewed indicate that the licensee "up-charges" various pass through fees. This constitutes a violation of 3500.14 (c) and section 8(b) of RESPA which states in part "No person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally regulated mortgage loan other than services actually performed."
- The Truth in Lending disclosures that were reviewed incorrectly disclosed the amount financed, the amount of the finance charge, and the annual percentage rates.
- The Company does limited media advertising through print and the Internet. Review of the advertisements revealed that they were not in compliance with Regulation Z, 12 C.F.R. 226.24(c).
- The audited financial statements for 1999 and 2000 indicated "the Company has no liquidity and is insolvent."

[53] Copies of the examinations of FRM are attached as Exhibit 5.
[54] RSA 383:9.

- The Company did not have a formal procedure manual, and the originators are trained orally.
- The Company indicated that loans were table funded through various lenders, but loan files indicated that loans closed in the name of a single correspondent lender.
- The examiner could not verify payments to third parties on behalf of borrower.
- Credit report fees were inflated.

The examiner concluded that "[t]he licensee fails to conduct its business in accordance with the intent and purpose of the First Mortgage Bankers statute, RSA 397-A and the Federal Laws that govern mortgage lending." The examiner expressed his opinion in an interview that, as of 2001, FRM was sufficiently out of compliance that it would have been appropriate to revoked its license. The 2001 examination, however, did not result in a referral for enforcement by the examiner, and no action against the company was taken based on the 2001 examination.

The next examination was performed in 2003. W. Robert Duclos was the Examiner in Charge. That exam found, in part:

- Review of the loan files revealed that the truth in lending notices, mortgages, notes, good-faith-estimates, appraisals, and credit reports were not present in all of the files. These documents must be maintained with the files. The remainder of the files appeared to contain the necessary documents.
- The yield spread premium was not properly disclosed on good-faith estimates in violation of RESPA.
- There were at least 14 missing documents in the sixteen loan files reviewed, making it difficult to determine compliance.
- On all advertising, letterhead, forms, and communications, the name "Financial Resources, Inc." was used instead of the name approved on the license, "Financial Resources Assistance of the Lakes Region, Inc."
- Finance charges were understated by more than $100.00, the threshold limit allowed by Truth-In-Lending (Regulation Z) 226.18(d).
- By understating the loans by thousands of dollars, the annual percentage rate (APR) was similarly understated.
- The annual report received on January 31, 2003 for the year 2002 indicated that there were 142 loans for $18,757,068. Counting the loans on the supporting data there were only 138 loans representing $18,079.118.

The 2003 examination did not result in a referral for enforcement.

The next examination in 2004 (H. Kurt Gilles was the Examiner in Charge) included, in part, the following observations:

- In response to the examination questionnaire, FRM replied to the effect the licensee was undergoing investigation by the Securities Bureau and was in the midst of a civil suit. FRM had previously failed to notify the Banking Department about either the investigation or civil suit as it was required to do.

- Despite representations made in FRM's response to the previous report of examination that it would correct such improprieties, FRM continued to disclose business names such as "Financial Resources Inc." and "Financial Resources" on various documentation.
- The licensee verbally told the examiner how sensitive documents and confidential information were collected, retained and disposed of. The examiner was advised that the process of disposing of sensitive documentation required the physical shredding of such documents by two designated employees using a machine at FRM for that purpose. The examiner in charge asked Farah if he could physically inspect and collect trash from a dumpster used by FRM. The bank examiners took custody of two large plastic bags of trash picked from the dumpster. Subsequent analysis of the contents of the two trash bags revealed dozens of sensitive documents containing confidential private consumer information that had not been shredded or otherwise disposed of properly. The documents included consumer credit reports, tax returns, real estate appraisals, insurance information and completed uniform residential loan applications.
- The licensee stated to the examiner that no complaints had been received. This was contradicted by information on the Banking Department's database.

Prior to the 2004 examination, the Banking Department received a tip indicating that FRM was disposing of confidential information in its dumpster. The information indicated that bears would go into the dumpster, tear up bags, allowing confidential documents to be scattered in the wind. As is noted above, during the course of the 2004 exam, Farah was specifically asked about his document disposal policy. Farah informed the examiner that two employees of FRM had been designated to shred sensitive documentation prior to disposal using a machine at FRM for that purpose. Notwithstanding this claim by Farah, the examiner found two bags of trash in the dumpster with sensitive client information. This was consistent with the allegation that the Banking Department received from the tip. In addition to the improper disposal of confidential information, the examination report noted that FRM did not have a written policy outlining its privacy and security procedures and practices.

The examination report also expressed frustration regarding the ongoing use of unlicensed trade names. The examiner noted that following the 2003 exam, Mr. Farah sent a letter dated August 19, 2003 that stated, relative to the use of an unlicensed trade name,

> [w]e are in the process of applying for a d/b/a to stay in compliance with this guideline. We would prefer to use Financial Resources, Inc. on all our forms, letterhead, business cards, etc. If, in the event we are denied the d/b/a, we will change our forms, etc to Financial Resources and Assistance of the Lakes Region, Inc.

In 2004, the examiner contacted the Secretary of State's office, Corporate Division. The examiner was told that not only had the Secretary of State's Office not approved any changes in the use of FRM's business name, but also that it had not received an application from FRM requesting a trade name since the prior examination in 2003.

In response to the apparent misinformation provided by Farah, the examiner wrote:

> The commissioner may by order, upon due notice and opportunity for hearing, assess penalties or deny, suspend, or revoke a license if it is in the public interest and the applicant or licensee ... [if the licensee] has made a false or misleading statement to the commissioner or in any reports to the commissioner.

Unlike the prior two examinations, the 2004 examination did result in a referral to the Banking Department's legal unit for enforcement. *See* Section C below for a description of the enforcement effort. Among the issues raised in the referral were violations of the Gramm-Leach-Bliley Act's requirements to have a written policy outlining their privacy and security procedures and practices. The confidential documents found in the dumpster clearly evidenced violations of the Act. In addition, the referral included a violation for failure to facilitate an examination in light of Farah's inability to provide documents necessary to conduct an examination.

The Banking Department conducted an examination of FRM in May 2006. Kerry R. Molin was the Examiner in Charge. The examiner noted that there were "numerous errors [in] and adjustments" required to FRM's Statement of Condition. Using italics for emphasis, the examiner stated that "*Licensee does not maintain a General Ledger and financial records. The CPA reconciles bank statements quarterly and prepares audited financial statements on a cash basis for the year ending December 31*." (Emphasis in original.) The examiner also noted that FRM "failed to provide a copy of an Operating account register. The licensee does not maintain a general ledger and general journal. Records are keep [sic] manually. *Income and expense are record [sic] in the Check registers only*. Multiple accounts used at multiple financial institutions." (Emphasis added.)

Some of the observations that had been made in the prior examinations continued to appear, including the use of unlicensed trade names, failure to reference the Banking Department's license on its website, failure to report significant events (the lawsuit by the investors referenced in the April 2006 Concord Monitor article and another lawsuit), and continued poor record keeping that impacted the ability of Banking to perform a complete examination. FRM failed to notify the Banking Department of a change of ownership as it sold shares of stock in the company.

With regard to the issues raised in the 2004 referral for enforcement, the 2006 exam found that FRM continued to violate the Gramm-Leach-Bliley Act's requirements to have a written policy outlining their privacy and security procedures and practices. The examiners found that a security plan had not been designed, implemented or tested, nor had FRM entered into privacy agreements with third parties who had access to confidential information. The 2006 examination resulted in a second referral for enforcement to the legal unit.

On October 13, 2006, FRM hired the law firm of Gallagher, Callahan & Gartrell to do an assessment of operations with regard to the Gramm-Leach-Bliley Act. In June 2007, another examination was performed of FRM by the Banking Department. The 2007 examination resulted in a significant number of observations, many of which were repeat violations. Mr. Molin was again the Examiner in Charge. The 2007 examination, however, did not result in a referral for enforcement to the Department's legal unit. Examiner Molin stated in an interview that he observed significant improvements regarding compliance with Gramm-Leach-Bliley's privacy requirements. FRM did, for the first time, have a policy for safeguarding consumer information, and did have shredders on site, but the policy did not include the monitoring of service providers, and did not include a requirement for annual evaluations and adjustments. Examiner Molin also noted that by the time of the 2007 examination, FRM was working with a law firm to advise on compliance with Banking's requirements. He concluded that overall, the 2007 examination showed significant improvements over past examinations.[55]

The next examination was conducted in November 2008. Lorry D. Cloutier was the Examiner in Charge. Phase I of the 2008 examination was a targeted exam of limited scope. Following the targeted examination, the examiner made a referral for an expanded examination. The examiner noted (1) significant concerns from the previous exams; (2) FRM was currently under investigation by the Securities Division; (3) exam materials for the 2008 examination were not received within 21 days; (4) FRM provided inaccurate supporting documentation in its annual report; and (5) FRM was the subject of excessive consumer complaints. The expanded examination was approved, and Phase II of the examination was conducted in March 2009.

The 2009 exam report noted that FRM was again working with unlicensed entities – unlicensed lenders (Sun State Capital Management and RGM Investment Realty Trust) and an unlicensed servicer, CLM.[56] The 2008 examination also identified record keeping problems with FRM, a problem that existed in virtually every prior examination. By the 2008 examination, however, FRM had "improved and updated [its] safeguarding policy." FRM was unable, however, to document tests and reviews of the safeguarding policy. FRM was also again found not to have agreements with third party service providers to ensure privacy of records.

The Banking Department's jurisdiction was limited to mortgages on owner occupied single family homes and dwellings not exceeding 4 units and manufactured housing. Commercial mortgages were outside of its jurisdiction. The Banking Department identified the following residential first and second mortgages brokered by FRM as follows:[57]

Year	Number of 1st Residential Mortgages Brokered (RSA 397-A)	Number of 2nd Residential Mortgages Brokered (RSA 397-A)	Number of loans serviced by FRM (RSA 397-B)	Number of Loans Funded by FRM (RSA 397-A)
1997	88	0	0	
1998	126	0	0	
1999	128	4	0	

55 This conclusion appears to be inconsistent with the findings in the examination report. Numerous repeat violations were observed, although many were not noted in the examination report as repeat violations. The examiner and legal unit, however, appeared to be satisfied that FRM had hired a law firm to assist it, observed some level of improvement, and concluded that further enforcement was not warranted. The conclusion also appears to be inconsistent with the referral for an expanded examination noted in the discussion of the 2008 examination.

56 In response to the discovery that CLM was conducting unlicensed servicing of residential loans, the four loans that were being serviced were transferred to FRM, the licensed entity. The Banking Department took no administrative action against CLM for that violation.

57 The data in this chart was provided by the Banking Department. It was not confirmed for accuracy.

Year	Number of 1st Residential Mortgages Brokered (RSA 397-A)	Number of 2nd Residential Mortgages Brokered (RSA 397-A)	Number of loans serviced by FRM (RSA 397-B)	Number of Loans Funded by FRM (RSA 397-A)
2000	125	2	0	
2001	146	0	0	
2002	142	0	0	
2003	154	0	0	
2004	92	12	0	
2005	90	28	0	1
2006	65	21	0	5
2007	59	10	0	
2008	19	0	0	
2009	Unknown	Unknown	4 (transferred from CLM)[58]	

C. Consumer Complaints Filed With Banking

The Banking Department received fifteen complaints (including one non-consumer tip) over the course of ten years. The complaints are summarized as follows:

February 1, 1999: Complaint regarding mortgage held on New Jersey property. The complaint was referred to NJ Banking Department and the Banking file was closed.

December 14, 2001: Complaint alleged mortgage application was taking too long. Determination was made that company had not violated any banking laws.

March 18, 2003: Complaint (referred by DOJ) alleged company mishandled funds and application of payments. The Banking Department forwarded complaint to the company. The company proposed a resolution, but no response was received from the consumer.

April 14, 2003: Complaint alleged company denied a loan with no written explanation. Determination was made that company had not violated any banking laws.

September 12, 2003: Complaint alleged that a mortgage application fee was not returned to the consumer. Banking determined the complaint involved a commercial transaction and was not within its jurisdiction.

October 3, 2003: Complaint alleged the company was engaged in unlicensed mortgage activity. Banking determined the complaint was not within its jurisdiction.

[58] CLM had serviced these residential loans without a license. They were transferred to FRM, the entity licensed by the Banking Department following an examination by Banking.

October 6, 2004: Tip (not a consumer complaint) (referred by DOJ) from alleged improper loan procedures and document handling practices at Financial Resources.

January 19, 2005: Complaint received by Banking that the company changed the terms of an agreement without notice. Company addressed the matter and no further action was taken.

February 3, 2006: Complaint received by Banking regarding a mortgage application. Determination was made that company had not violated any banking laws.

February 22, 2006: Complaint (referred by DOJ) received by Banking regarding misrepresentation in a mortgage transaction. Determination was made that company had not violated any banking laws.

April 4, 2007: Complaint (referred by DOJ) alleged consumer was told she could refinance and receive a home equity line of credit, but never got the line of credit. The complaint was referred to the North Carolina Banking Department because the property was located in North Carolina.

February 25, 2008: Complaint alleged FRM overcharged for a loan. Banking concluded it had no jurisdiction.

May 20, 2008: Complaint alleged that a mortgage customer did not receive any information prior to loan closing. Banking records did not indicate the complaint was resolved.

May 20, 2008: Complaint alleged that the company failed to honor verbal and written agreements. Determination was made that company had not violated any banking laws.

July 9, 2008: Complaint (referred by DOJ) alleged inaccurate information on Truth-in-Lending Statement and that the consumer did not know about a balloon note. The complaint is unresolved, with a note in the database that an examiner may want to review company's response.

D. Administrative Enforcement

Following the 2004 examination, but not until October 2005, the first referral was made to the legal unit for enforcement.[59] On December 16, 2005, Andrea Shaw, Staff Attorney for the Banking Department, filed a Statement of Allegations.[60] The Statement of Allegations included three counts: Failure to implement a program to safeguard consumers' sensitive financial information; failure to have a written safeguard plan; and failure to facilitate an examination. Attorney Shaw concluded that the allegations outlined in the Statement of Allegations were

[59] There was a significant delay between the date the examination began, and the date the report was finalized and the referral made. No explanation was apparent, but the Supervisor of Examiners believed it was due in part to work load and slow response by FRM to provide information.
[60] Exhibit19.

sufficient to constitute good cause to revoke FRM's New Hampshire mortgage lending license, and the revocation was in the public interest as FRM "and Mr. Farah have illustrated a willingness to forgo the laws and rules of the State of New Hampshire whenever they see fit."

On December 20, 2005, the Banking Department issued an Order to Show Cause for License Revocation based upon the December 16, 2005 Statement of Allegations. The Order required FRM and Farah to show cause as to why FRM's license should not be revoked and a $17,000 fine should not be imposed.[61] Attorney Michael Burke appeared on behalf of FRM and Farah, filed an Answer and requested a hearing. The Banking Department appointed a hearing officer, and scheduled a hearing for March 9, 2006.[62] The hearing was postponed by agreement by Attorney Shaw and Attorney Burke in order to engage in settlement discussions.

On February 17, 2006, Attorney Shaw and Attorney Burke discussed the possibility of entering into a consent agreement. On February 23, 2006, the Supervisor of Examiners notified Attorney Shaw that FRM was scheduled for another examination. He asked Attorney Shaw if he should go ahead and schedule the examination. Attorney Shaw requested that he hold off scheduling the exam "until we have a [solid] agreement in place – then if he has a repeat violation of Gramm Leach Bliley we can get him for violating an Order of the Commissioner as well." On April 24, 2006, Attorney Shaw notified Michael Burke that the Banking Department's General Counsel was reviewing a draft Consent Order.[63]

The next day, on April 25, 2006, the Concord Monitor published an article describing a civil action filed against Farah and his father, Robert Farah, the Pastor of the Center Harbor Christian Church.[64] On that same day, Attorney Shaw suggested to Banking's General Counsel that "[w]e would like to fast track it [the consent order] and try to get it wrapped up as soon as possible in light of today's newspaper article. We are planning an unannounced examination in the near future."[65]

By April 27, 2006, the Banking Department decided to proceed with its scheduled examination. On April 27, 2006, Mary Jurta wrote to the Supervisor of Examiners and advised him that she "spoke to PCH [Peter Hildreth] today and he said I should get in touch with Securities and let them know we are going back to Financial Resources on a routine exam, and see if they wanted to accompany us. I left a voice mail for Barry Glennon [of the Securities Bureau]." Ms. Jurta does not recall if she said in her voice mail message that the exam would be an unannounced exam, or if she only used the words "routine exam." On May 4, 2006, the Securities Bureau staff attorney left Ms. Jurta a message that Securities would "go up separately" and that he had "called Denis Maloney," counsel for FRM.

By May 24, 2006, the Banking Department's General Counsel had decided to discontinue negotiations with FRM on the enforcement action. Attorney Shaw had decided that the case against FRM "should be a straight forward revocation if we base it in part on not implementing a

61 Exhibit 20.
62 Exhibit 21.
63 Exhibit 22.
64 Exhibit 14.
65 Exhibit 23.

GLBA program."[66] Mary Jurta agreed with that position, and noted that she "would recommend that we not engage in any further settlement negotiations, but instead prepare to issue a show cause for license revocation when the [2006] exam is complete."[67]

The 2006 Banking Department examination prompted a second referral for enforcement, on much the same basis as the previous referral. No action, however, was ever taken on the administrative petition, and following the 2007 examination, on February 29, 2007, the new Staff Attorney, James Shepard, closed the matter. He made the following notation in the Banking Department's records: "2/29/07 Delay for unknown reasons. In the meantime nex[t] exam went down and they had essentially fixed all outstanding issues. Closing case without further action."

Although Attorney Shaw did not provide input into this Report, her workload was described as heavy. The Banking Department's General Counsel, Donna Soucy, said Attorney Shaw had little or no administrative support. From approximately the end of 2005-2006, she was actively involved in a nationwide enforcement action against Ameriquest. That case resulted in a nationwide settlement in March of 2006. The investigation and research involved in that case consumed much of her time in the six months prior to reaching a settlement. Attorney Shaw left her position in the Consumer Credit Division, and moved to the Banking Division in approximately June 2006. A replacement was not hired until September 2006.

E. Conflict of Interest – Peter Hildreth

Peter Hildreth was the Director of the Securities Bureau from August 1992 to September 2001. On April 18, 2001, Mary Jurta and Jeff Spill met with Gary Coyne in Meredith to review FRM's business records. During the course of that meeting, they noted that Mr. Hildreth's brother had invested money with the company. Upon returning to the office, Mary Jurta informed Mr. Hildreth that his brother was involved with the company. Mr. Hildreth said, as a result, he would not be involved in anything relating to the company. Mr. Hildreth recalls being told about Gary Coyne, but does not have any recollection of having been told the name of the company or Scott Farah's name. There is no documentation of his recusal. From the time he was told of his brother's involvement in the investigation until he left the Securities Bureau, Mr. Hildreth had no further involvement with the investigation by the Securities Bureau,

On September 20, 2001, Mr. Hildreth became the Commissioner of the Banking Department. During one of the early examinations of FRM, Commissioner Hildreth's brother was again identified by the examiner as investor of the company. Mary Jurta, who had by then transferred to the Banking Department, again informed Commissioner Hildreth that his brother's name had appeared in documents related to FRM. Commissioner Hildreth told Ms. Jurta that he would continue to be recused from matters dealing with the company. This recusal at the Banking Department was not put in writing.

An April 25, 2006, the Concord Monitor published its article on Farah and the Center Harbor Christian Church.[68] On April 27, 2006, Ms. Jurta spoke with Commissioner Hildreth

[66] Exhibit 23.
[67] Exhibit 23.
[68] Exhibit 14.

about the upcoming examination of FRM.[69] Commissioner Hildreth told Ms. Jurta that she should get in touch with the Securities Bureau and ask if Securities wanted to conduct a joint examination with the Banking Department.[70] On April 27, 2006, Andrea Shaw wrote memos directed to Commissioner Hildreth's attention regarding the number of complaints that had been filed against FRM, and the status of the administrative action pending against FRM.[71] Attorney Shaw also faxed, at Commissioner Hildreth's request, a copy of the Show Cause order to a reporter for the Concord Monitor.[72]

Although Commissioner Hildreth asserted recusal from FRM, the files show evidence of his participation in the matter in 2006. No evidence reviewed, however, indicates that he directed his staff to take a particular action during any examination of FRM, or interfered with the administrative enforcement action taken by the Banking Department. Commissioner Hildreth does not recall either the April 27, 2006 conversation with Ms. Jurta, or the memos from Attorney Shaw. Attorney Shaw declined to speak to DOJ during this review. Thus, the only direct evidence available is the written record.

F. Findings and Conclusions

Finding #1: The Banking Department failed in its mission to ensure that FRM complied with sound financial management and compliance with state and federal laws and regulations. The Banking Department had responsibility for ensuring that the institutions it licenses, regulates and supervises as mortgage bankers and mortgage brokers (1) conduct business in a manner consistent with the public interest and (2) comply with applicable laws including consumer protection laws governing the business in which the licensees are engaged.

The Banking Department was and is required by statute to obtain, among other information, from an applicant for a mortgage banker's or broker's license the qualifications and business history of the applicant and its principals, and the applicant's financial condition and history. RSA 397-A:5(I). An applicant is also required to disclose, among other items of information, whether the applicant or any principal has ever been convicted of any of a number of financial crimes including fraud, false statements or omissions, theft or any wrongful taking of property. *Id*. Each applicant is required to provide information sufficient for the Banking Department to determine the applicant's ability to conduct business with "*financial integrity*." RSA 397-A: 5(III)(c) (emphasis supplied.). A statement of net worth is required of each applicant. *Id*. A surety bond is required to be posted by each licensee. Id. Net worth statements provided in connection with an application for a license are subject to "review and verification *during the course of any examination or investigation*" conducted under RSA 397-A:12 (emphasis supplied).

The Commissioner has broad authority to examine the "business affairs" of any licensee as he may deem necessary to determine compliance with the laws governing mortgage bankers and brokers. RSA 397-A:12(I). All books, papers, files, related material, and records of assets

[69] Exhibit 23.
[70] Exhibit 23.
[71] Exhibit 32.
[72] Exhibit.31.

of a mortgage banker or broker are subject to the banking department's examination authority. The examiner is required to "report any violations of law, rule, or *standard business practice* to the banking department." RSA 397-A:12(IV) (emphasis supplied). Every person being examined "shall make freely available to the commissioner or his or her examiners, the accounts, records, documents, files, information, assets, and matters in their possession or control relating to the subject of the examination and shall facilitate the examination." RSA 397-A:12(VII).

Upon receipt of a written report of examination, the licensee has "30 days or such additional reasonable period as the commissioner for good cause may allow, within which to review the report, recommend any changes and set forth in writing the remedial course of action the licensee will pursue to correct any reported deficiencies outlined in the report." RSA 397-A:12(VIII). The Commissioner may issue an order requiring any licensed mortgage banker or broker to show cause why the license should not be revoked or suspended, or penalties imposed, or both, for violations of the laws governing mortgage bankers and brokers. RSA 397-A:17. In addition, the banking department may issue a cease and desist order against any licensee or person who it has reasonable cause to believe is in violation of the laws governing mortgage bankers and brokers or any rule or order issued under those laws. RSA 397-A:18.

During each examination of FRM, the Banking Department's overall mission was to ensure that FRM continued to satisfy the basic business, financial, governance and operational standards that the statute and regulations require. However, as early as 2001, the examination found numerous violations of law and the examiner determined that the audited financial statements for 1999 and 2000 indicated that FRM "has no liquidity" and "is insolvent." FRM "did not have a formal procedure manual," and loan originators were trained orally. FRM indicated that loans were table funded through various lenders, but loan files indicated that loans closed in the name of a single correspondent lender. The examiner could not verify payments to third parties on behalf of borrowers. Credit report fees were inflated. The examiner concluded that "[t]he licensee fails to conduct its business in accordance with the intent and purpose" of RSA 397-A and federal laws governing mortgage lending. The examiner expressed his opinion in an interview that, as of 2001, FRM was sufficiently out of compliance that it would have been appropriate to have revoked FRM's license. The 2001 examination, however, did not result in a referral for enforcement by the examiner, and no action against the company was taken based on the 2001 examination.

The 2003 and 2004 examinations revealed both new and repeat violations. FRM misrepresented its document disposal practice and its efforts to obtain a trade name. FRM failed to correct past violations, and simply continued committing the same violations over and over again.

In 2006, the examiner noted that there were "numerous errors [in] and adjustments" required to FRM's Statement of Condition. Using italics for emphasis, the examiner stated that "*Licensee does not maintain a General Ledger and financial records. The CPA reconciles bank statements quarterly and prepares audited financial statements on a cash basis for the year ending December 31*." (Emphasis in original.) The examiner also noted that FRM "failed to provide a copy of an Operating account register. The licensee does not maintain a general ledger and general journal. Records are keep [sic] manually. *Income and expense are record [sic] in* *the Check registers only*. Multiple accounts used at multiple financial institutions." (Emphasis added.)

As stated above, a fundamental part of the Consumer Credit Division's mission is ensuring that a licensed mortgage banker and broker is viable, adequately capitalized, managed by competent and honest individuals, submits annual and other reports in a timely fashion, maintains adequate records, can identify and provide information with respect to its shareholders, cooperates with examiners and regulators, maintains a general ledger, maintains accurate and useful financial statements, corrects violations of law, addresses examiners' other criticisms, and satisfies the Banking Department that it operates in a manner consistent with the public interest and in compliance with applicable laws.

The examinations of FRM early on and throughout the relevant period revealed a company that failed to satisfy the requirements summarized above. The examinations of FRM revealed a company that lacked basic, adequate policies, procedures and controls, and a corporate culture that suggested a fundamental disregard of basic business, financial, governance and operational norms. These should have been red flags. The Banking Department's failure was not necessarily that it failed to identify a Ponzi scheme. Instead, the Banking Department failed in its mission to ensure that FRM conducted its business in a manner consistent with the public interest and applicable state and federal laws and regulations.

Finding #2: The Banking Department's enforcement action against FRM was deficient. By 2004, the Banking Department recognized that FRM was operating in violation of state and federal laws and regulations. The Banking Department initiated a limited enforcement action against FRM, but thereafter failed to perform its role as regulator and supervisor of the licensee. In 2004, after Farah described what he purported to be a policy of shredding confidential consumer information, banking examiners found bags of confidential information that had not been shredded in trash bags in the dumpster. In 2006, Farah still did not have a proper record destruction policy.

Every exam found that FRM used a variety of unlicensed trade names in its operations. In 2003, Farah wrote to the Banking Department that he was in the process of applying for a trade name. In 2004, however, examiners learned that, despite these representations to the Banking Department, no such application for a trade name had been filed.

Every examination noted the poor record keeping maintained by FRM, making it difficult at times for the examiners to perform their jobs.

In 2005, the Banking Department took action against FRM. A negotiated settlement was possible in 2006, but the Banking Department decided to withdraw from settlement negotiations. Instead, the Banking Department concluded that the case was sufficiently strong to seek revocation of FRM's license. Yet, despite two referrals for enforcement from the examiners, despite the conclusion by staff that sufficient basis existed to revoke the license, despite the evidence of violations of law and false statements to regulators, the administrative petition never reached a hearing phase. In 2007, a new staff attorney closed the matter citing "delay for unknown reasons."

The violations observed during the course of the examination resulted in actual or potential consumer harm. The record keeping violations and improper disposal of consumer confidential information is unacceptable. It is unknown how long confidential information was simply thrown out with the trash, or whether any consumer information was ever misused as a result. Even the Banking Department's own training materials by 2006 describe the requirements regarding safeguarding consumer's sensitive financial information as "serious" and that these violations are most likely going to be referred to enforcement. The RESPA violations observed in various examinations may have impacted a consumer's ability to adequately compare loan terms and costs with other lenders.

Each step of the enforcement process failed. FRM committed numerous, serious, repeat violations of the law. No hearing was held, and the 2005 enforcement action was allowed to flow into the next examination without an order or agreement. The 2006 examination resulted in a second referral, but the enforcement action languished. No hearing was held in 2006, and by 2007, a new staff attorney was working in the Consumer Credit Division, FRM had hired a law firm to help bring it into compliance, and the staff attorney was getting feedback that the 2007 examination indicated improvement in the company's operation. The lawyer concluded that, in light of the passage of time, the indications of improvement, and the presence of an apparent effort to work with professionals that the enforcement action should be simply closed without action.

As was discussed in Section VI. C above, simply initiating an enforcement action does not result in any legally useful result. It is only by way of an order or executed settlement agreement that a decision can become binding, and the penalties and injunctions that are ordered become enforceable. If orders or agreements are never finalized, there are no consequences to prevent a company from simply committing additional violations. Simply initiating an action does not provide consumers with meaningful protection.

<u>Finding #3</u>: Peter Hildreth failed to implement and follow a policy of recusal. Commissioner Hildreth acknowledged that, when he learned that his brother was an investor in FRM, he should have no involvement with the company. The records at the Banking Department indicate the recusal was not put in writing, and there is no record in the FRM files to indicate the staff was generally aware of his recusal. Actions were taken inconsistent with a recusal policy, including directing staff to contact the Securities Bureau, receiving a memorandum from staff counsel on the status of enforcement proceeding and receiving a memorandum describing the complaints filed with the Banking Department against FRM.

VIII. RELATIONSHIP BETWEEN BANKING DEPARTMENT AND SECURITIES BUREAU

One need only read the December and January headlines to conclude that the relationship between the Securities Bureau and the Banking Department had become toxic.[73] Fundamentally,

[73] *How Alleged 'Ponzi' Firm Fell Through Regulatory Cracks*, N.H. Business Review, December 18-30, 2009; *N.H. Securities Chief Subpoenas Banking Department's Records in FRM Case*, Laconia Daily Sun, January 20, 2010;

if agencies cannot work together, they will be unable to fulfill their primary function of providing service and protection to the citizens of the State. Communication among regulators is an essential function of state government. One example of the failure of communication and the mistrust that existed between Banking and Securities occurred in 2006 when the Banking Department was preparing to conduct an unannounced audit of FRM. The Banking Department, through a voice mail message on April 27, 2006, asked the Securities Bureau if they would wanted to hold a joint examination with Banking. By way of reply voice mail on May 4, 2006, the Securities Bureau responded that they would go separately, and they had called the lawyer for FRM. In this simple exchange of voice mail, the Banking Department believed it had invited Securities to an unannounced exam of FRM, and heard in the reply voice mail that Securities had not only declined to conduct a joint examination, but it had told the lawyer for FRM that Banking was going to perform an unannounced examination. In reality, the Securities Bureau, in response to a call from an investor and the Concord Monitor article of April 2006, had already concluded it would meet with Farah. The call from the Securities Bureau made to FRM's counsel did not involve the Banking Department's unannounced examination, but was simply a call to coordinate a meeting by the Securities Bureau it was already planning to schedule.

An essential task of all state agencies is to determine how information can be reasonably and efficiently shared among one another, and to share information with the public. Section X of this Report includes recommendations for information sharing, coordination of efforts and public disclosure.

IX. DEPARTMENT OF JUSTICE

A. Jurisdiction

As it relates to the issues discussed in this Report, the Department of Justice ("DOJ") has jurisdiction under the Consumer Protection Act, RSA 358-A, to investigate and prosecute unfair or deceptive acts or practices in the conduct of any trade or commerce within the State. Since 2002, the Consumer Protection Act has exempted trade or commerce regulated by the Banking Department, Securities Bureau, Insurance Department or the Public Utilities Commission.[74]

The DOJ also has the statutory obligation, through its Bureau of Civil Law, to provide "advice and legal representation in civil matters for all executive branch agencies."[75] The Civil Bureau is currently divided into a litigation unit and a client counseling unit. These units did not exist, however, in 2003. Instead, prior to the development of separate units, lawyers in the Civil Bureau performed both functions. Among the approximately 115 agencies, boards, commissions and councils represented by the Civil Bureau are the Banking Department and the Secretary of State (including the Securities Bureau). DOJ also has jurisdiction, through the Criminal Justice Bureau, alone or in conjunction with other law enforcement agencies, to investigate and prosecute crimes as directed by the attorney general.[76]

Ponzi Case Exposes Chiefs' Rift, Securities, Banking Heads Feud Over Their Authority, Concord Monitor, February 7, 2010.

[74] RSA 358-A:3.

[75] RSA 21-M:11.

[76] RSA 21-M:8.

B. Legislation Affecting DOJ's Jurisdiction

1. Chapter 12:1, Laws of 2001

On November 15, 2001, the Final Report of the committee charged with studying the consumer protection effort in New Hampshire[77] was issued. That study committee recommended, among other things:

- A significant increase in the resources allocated to the Attorney General's office, Bureau of Consumer Protection, to provide adequate manpower to investigate and prosecute consumer fraud.
- A careful review and analysis by the legislature of the scope and breadth of the "regulated industries" exemption of the Consumer Protection Statute to determine if adequate supervision and control of business activities of regulated entities exists to protect the consumer.
- A clarification of statutory language to assure a right of private action for abuses in areas of business not actively regulated by state supervisory authorities.

These three findings lead to House Bill 1429 (2002) and House Bill 1437 (2002), discussed below. In addition, the report recommended "improved coordination and communication between the various regulatory departments and authorities to better assess and define the scope and magnitude of the problem, and to coordinate effective remedy." That finding is discussed in more detail in Section X of this Report.

2. House Bill 1429 (2002) (Relative to the Scope of the Consumer Protection Act[78]

In 2002, the General Court made a substantial change to the Consumer Protection Act, RSA 358-A by creating certain exemptions to the Act. House Bill 1429 ("HB 1429") added the following exemption to the Act:

The following transactions shall be exempt from the provisions of [the Consumer Protection Act]:

> Trade or commerce that is subject to the jurisdiction of the bank commissioner, the director of securities regulation, the insurance commissioner, the public utilities commission, the financial institutions and insurance regulators of other states, or federal banking or securities regulators who possess the authority to regulate unfair or deceptive trade practices.

[77] Chapter 12:1, Laws of 2001. A copy of the report is attached as Exhibit 24.
[78] The legislative history for HB1429 is attached as Exhibit 25.

As a result of this legislation, consumers who may otherwise have been authorized to pursue Consumer Protection Act claims against entities subject to the jurisdiction of the Banking Department or the Securities Bureau were no longer allowed, by law, to pursue such claims. Instead, they became dependent upon action that may or may not be taken by the Director of Securities or the Banking Commissioner. As a result of this legislation, not even the Attorney General is authorized to pursue claims of restitution on behalf of consumers under the Consumer Protection Act.

HB 1429, as originally introduced, would only have excluded trade or commerce if it was *expressly permitted* under laws, rules, standards or regulations of applicable regulators. If not expressly authorized, the Attorney General would have the authority to investigate and prosecute violations of the Act, and Consumers would have been free to pursue restitution

Assistant Attorney General David Rienzo presented the following testimony in support of the proposed language as introduced as follows:

> This provision of the Bill would be of great help to the Bureau because when a complaint alleging an unfair or deceptive act is received, and the complaint is against a member of an industry which is covered by specific laws or rules, the Bureau would be able to determine whether the acts alleged are permitted by those rules or regulations. If so, they would be wholly exempt from the Consumer Protection Act, and the Bureau would be unable to take any action. If, however, the acts alleged are not specifically permitted by the regulating agency because they are disallowed, or because the statutes and regulations are silent regarding the acts, the Bureau would have the ability to analyze them under the standards of RSA 358-A. This would reduce confusion relating to the jurisdiction of RSA 358-A, and allow the Bureau to concentrate more of its time on its core mission of protecting consumers.

On the floor of the Senate, the bill was amended to:

> Trade or commerce by any person who is subject to laws, regulations, standards, orders, or other action of a federal or state regulatory authority that regulates unfair or deceptive acts or practices in the conduct of such trade or commerce, and who is regularly examined for compliance with such laws, regulations, standards, orders, or other action by a federal or state regulatory authority or is subject to sanctions or remedial action by such authority, including without limitation restitution, reparation, or damages which may be ordered by such authority or may otherwise be available to the injured person by statute or regulation, for failure to comply with such laws, regulations, standards, orders, or other action, such as a banking, insurance. or utility company.

Because the Senate language differed from the House language, HB 1429 was sent to a Committee of Conference. The Committee of Conference amended the bill to its final form.[79]

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[79] Senate Journal 14, May 2, 2002 (http://www.gencourt.state.nh.us/scaljourns/Journals/2002/senjou14.html).

As originally proposed, the bill would have provided consumers and the Office of the Attorney General the authority to enforce consumer protection laws for fraudulent actions by lenders or securities dealers. As passed by the legislature, however, if the entity was regulated, (even if the activity was not authorized), all authority under the Consumer Protection Act was prohibited. Thus, activities where fraud is most likely to cause severe economic harm to consumers, banking and securities, was taken out of the hands of the consumers.

3. House Bill 816 (2003) – NH Securities Act[80]

At the request of the Securities Bureau, the General Court introduced House Bill 816 ("HB 816"). The original bill as introduced would have changed the NH Securities Act, RSA 421-B:23 as follows:[81]

> (b) The [~~attorney general~~] ***secretary of state or his or her designee*** may [~~, with or without prior administrative action by the secretary of state,~~] bring an action in the superior court to enjoin the acts or practices and to enforce compliance with this chapter or any rule or order under this chapter. Upon a proper showing, a permanent or temporary injunction, restraining order, or writ of mandamus shall be granted [~~and a receiver may be appointed for the defendant or the defendant's assets~~]. ***In addition, the court may issue an order for other appropriate or ancillary relief, to include an asset freeze, accounting, writ of attachment, writ of general or specific execution, and an appointment of a receiver or conservator, that may be the administrator, for the defendant or the defendant's assets.*** The court shall not require the [~~attorney general~~] ***secretary of state*** to post a bond; and

Thus, as proposed by the Securities Bureau, the Attorney General would have no authority to go into court to obtain injunctive relief against a company violating the securities laws. In addition, the bill added for the first time the authority to freeze assets. At the request of the Attorney General, the language as proposed by the Securities Bureau was modified to allow either the Attorney General or the Secretary of State to seek injunctive relief. Thus, effective in August of 2003, RSA 421-B:23 (I)(b) read as follows:

> The attorney general or secretary of state or his or her designee may, with or without prior administrative action by the secretary of state, bring an action in the superior court to enjoin the acts or practices and to enforce compliance with this chapter or any rule or order under this chapter. Upon a proper showing, a permanent or temporary injunction, restraining order, or writ of mandamus shall be granted. In addition, the court may issue an order for other appropriate or ancillary relief, to include an asset freeze, accounting, writ of attachment, writ of general or specific execution, and an appointment of a receiver or conservator,

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80 The legislative history of House Bill 816 is attached as Exhibit 27.

81 Language added to existing law in ***bold italics*** and language removed from existing law [~~in brackets and struckthrough~~].

> that may be the administrator, for the defendant or the defendant's assets. The court shall not require the attorney general or secretary of state to post a bond; and

During the testimony on the bill before the Senate, Jeffrey Spill, Staff Attorney at the Securities Bureau, testified:

> The initial version of the bill allowed for the Secretary of State's office to have enforcement authority whereas the bill before did not. The amendment allowed for the Secretary of State's office or the Attorney General's office to take enforcement action so the Attorney General's office would not loose [sic] jurisdiction. The reason for this requested change is on cases where we needed to act quickly or in cases where the resources of the Attorney General could not provide assistance, the Secretary of State's office would be allowed to go into court and enforce subpoena's [sic], enforce orders of the bureau and to freeze and appoint receivers for assets.
>
> Mr. Spill went on to say:
>
> The way the law originally read, when it came to enforcement action, enforcing our own orders or subpoenas or asking a receiver to step in and to freeze assets that jurisdiction was in the Attorney General's office. We found that at times that was cumbersome because at times they were short of resources and could not assist or would have a time delay in assisting. We thought it would be a better use of resources for us to have the authority to act if we needed to act. So this was not taking away authority from the Attorney General's office but allowing us along with the Attorney General's office to have jurisdiction.

C. Consumer Complaints Filed

The Consumer Bureau has received five complaints regarding FRM. Because complaints related to banking are not within the jurisdiction of the Consumer Bureau, the complaints were all referred to the Banking Department and the files were closed. The complaints are summarized as follows:[82]

CPB COMPLAINT #1
DATE FILED: January 22, 2003
STATUS: Closed, referred to Banking
SUMMARY: Complaint filed by a borrower against Financial Resources, Inc. of Tulsa, Oklahoma. Complaint alleged possible misuse of funds. Complaint stated the Company informed the borrower she was 14 months behind on her payments. She said the Company extended the payments for three additional years, but the Consumer stated she did not sign an agreement to extend payments. She also alleged the Company changed the amount of her payments. She discovered the extended payments on May 11, 2000. The complainant also alleged that the Company was required to withhold $60.00 per

[82] In accordance with RSA 21-M:9, "the [Consumer B]ureau may disclose to the public the number and type of complaints or inquiries filed by consumers against a particular person…."

month for taxes, but she was required to pay taxes herself on two occasions. The complaint was referred to the Banking Department on February 4, 2003 and the file was closed.

CPB COMPLAINT #2
DATE FILED: September 7, 2004
STATUS: Closed, referred to Banking
SUMMARY: Complaint filed against Financial Resources and Assistance of the Lakes Region, Inc. of Meredith, New Hampshire. Complaint alleged the Company regularly practiced predatory lending by mining their closed files and calling previous clients to refinance, thus continuously reusing the client's home equity. The complaint also alleged that the Company threw consumer paperwork with private information into a dumpster behind the building, and paperwork would be blown over the surrounding woods. The complaint alleged the Company passed itself off as a lender rather than a broker to keep prospective customers from realizing they were paying too much for a loan they could procure from a bank or other lender. The complaint was referred to the Banking Department on October 6, 2004 and the file was closed.

CPB COMPLAINT #3
DATE FILED: March 8, 2006
STATUS: Closed, referred to Banking
SUMMARY: Complaint by a borrower against Financial Resources alleging the Company induced him into a loan that the complainant had no choice but to rescind. The complainant stated he had contractors that needed to be paid, and a house available to be delivered. The complaint included a copy of a letter from the borrower's attorney rescinding the loan, dated February 21, 2006. The complaint was referred to the Banking Department on March 27, 2006 and the file was closed.

CPB COMPLAINT #4
DATE FILED: February 27, 2007
STATUS: Closed, referred to Banking
SUMMARY: Complaint by a borrower against Financial Resources alleged that the complainant received a call from the Company asking if he would like to refinance. They discussed loans that would allow complainant to pay off a mortgage, high interest rate credit cards and loans. Complainant only wanted to take out a home equity loan, but was told he would need to take out a first mortgage before he could get a home equity loan. He took out a loan to pay for appraiser based upon assurance that he would receive the home equity loan. Complainant received many requests for information, and received contradictory information about how much money he would be able to borrow. He signed a five year adjustable rate mortgage to pay off the balance of his previous 30 year fixed interest mortgage loan on assurances he would be able to get a second mortgage/home equity loan. He signed the paperwork for the first adjustable rate mortgage at the end of November 2006, and was told the second mortgage/home equity loan would be ready in two weeks. The complainant paid closing costs on the first mortgage, and added those costs to the total mortgage. After three months, the interest rate on his first mortgage loan increased by 3.6%. The complainant spent several months

trying to get answers from the Company, but was unable to get substantive responses. The complaint was referred to the Banking Department on April 3, 2007 and the file was closed.

CPB COMPLAINT #5
DATE FILED: June 30, 2008
STATUS: Closed, complaint also filed with Banking
SUMMARY: Complaint by a borrower against Financial Resource & Assistance of the Lakes Region alleged that the complainant applied for a $20,000 loan to pay off a town lien and other debts. The Company would only allow the borrower to take a minimum loan of $35,000. The first two years of payments were interest and fee payments, with a balloon payment of $35,379.17. The complainant fell behind on payments, and reached an agreement with the Company to pay $200 per week to catch up. He made the weekly payments, but fell behind on his regular monthly payments. Complainant believed he was the victim of a predatory lender. The complaint was filed with the Banking Department, and the file was closed.

D. Civil Bureau – Client Counseling Role[83]

On three occasions, the Staff Attorney from the Securities Bureau, Jeff Spill, met with Senior Assistant Attorney General Suzanne Gorman, to discuss FRM. The first meeting, on September 5, 2002, was to seek assistance with the issue of restitution to investors at issue in the Securities Bureau ongoing investigation of FRM. Following that meeting, Attorney Spill negotiated a stay of the Securities Bureau hearing on January 14, 2003.[84] Ultimately, FRM was unable to satisfy its obligations under the Stay, and a hearing was held on July 24, 2003. There is no evidence, based on interviews or documents, that the issues raised by Attorney Spill were brought to the attention of any of the leaders at DOJ, including Bureau Chief, Deputy Attorney General or Attorney General.

The second meeting between Attorney Spill and Senior AAG Gorman was on June 11, 2003, approximately one month before the scheduled administrative hearing. Attorney Spill asked Senior AAG Gorman about filing an action in superior court to freeze the assets of FRM. Attorney Spill stated in an interview that he was not requesting DOJ to investigate fraudulent activity because at that time he did not believe that there was fraudulent activity.

During the course of that meeting, they discussed Farah's desire to pay rescission on a pro rata basis, and the requirement under the Securities Act that requires full rescission. They also discussed the possibility of initiating an action in Superior Court to freeze FRM's assets.[85] They discussed the process involved with going to superior court, and "the various hoops" that they would need to jump through and the legal burden of proof they would have to meet. They

[83] All documents in the possession of the Civil Bureau regarding FRM are at Exhibit 28.
[84] Exhibit 12.
[85] Attorney Spill stated that the action he contemplated would be filed under the Securities Act. He stated he had no evidence of widespread fraud at that time. At the time, the Securities Act authorized the Attorney General to obtain a temporary or permanent injunction, restraining order, writ of mandamus or appointment of a receiver. The Securities Act was amended, effective on August 16, 2003, to allow the Attorney General or Secretary of State to seek an order for an asset freeze, accounting, attachment, or appointment of a conservator.

also discussed what assets existed (a house, the office building), some held in the name of FRM, some not. They also discussed the existence of accounts receivable. At the end of the conversation, Attorney Spill understood that the Department of Justice would not be filing an action in superior court although Senior AAG did not say that expressly.

After the meeting, Attorney Spill sent a letter to Senior AAG Gorman informing her that he would "wait to hear from you regarding the issue of securing assets for the benefit of the investors."[86] Attorney Spill said he sent the letter to document his position. Senior AAG Gorman has no memory of the conversation, but indicated that, given resource limitations and the fact that an administrative hearing was scheduled for only a month later, a separate superior court action would not typically be filed.

The third meeting between Attorney Spill and Senior AAG Gorman occurred over three years later on September 12, 2006. Although the purpose of the meeting was primarily to discuss another case in which a hearing had been held and no order issued, Attorney Spill said that at that meeting he told her a decision had not been issued by the hearing officer in the FRM case.

E. Contacts with Other DOJ Bureaus[87]

In addition to contacts between the Civil Bureau and the Securities Bureau described above, on October 3, 2005, the DOJ Investigator of the Day ("IOD") received a call alleging that the Center Harbor Christian Church and FRM were diverting monies from the church to FRM, and then back from the church to Scott Farah and his father. The caller also referred to a civil suit filed by two husband/wife investors. In response, the IOD and a Criminal Bureau attorney contacted the investors' attorney, Chris Carter. Attorney Carter informed them that he believed criminal violations existed, and that he would provide a copy of a supreme court brief and complaints.

Attorney Carter stated in an interview that he spoke by telephone with an investigator from the DOJ on May 3, 2006, regarding possible criminal actions against FRM, that he did not physically meet with anyone from DOJ, and that he did not know with whom he had spoken. DOJ has no record of the May 3, 2006 telephone call. The following day, on May 4, 2006, Attorney Carter met with federal officials regarding the case.

DOJ Investigator Michael Bahan recalls having a conversation with Attorney Carter regarding his client's case. In an interview, he said he spoke with Senior Assistant Attorney

[86] Exhibit 13.

[87] All of the records within the Criminal Bureau are attached as Exhibit 29. In addition, in September 2009, during the course of an unrelated bankruptcy proceeding, Senior Assistant Attorney General forwarded to Banking an email regarding a suspicious loan transaction involving FRM. A copy of Sr. AAG's email and the Banking Department's internal emails is attached as Exhibit 30.

In addition to the records attached, after FRM and CLM shut down in November 2009, the Criminal Bureau, in cooperation with the investigation conducted by the FBI and U.S. Attorney's Office, received numerous contacts from witnesses and investors. Those files are part of an ongoing criminal matter, and are not attached with this Report.

Simon Brown, who was the Bureau Chief of the Criminal Bureau at that time. Sr. AAG Brown concluded that, based on available resources, the Bureau would be unlikely to have the ability to investigate and, if appropriate, prosecute the matter. Shortly after the conversation with the Bureau Chief, Investigator Bahan was at a meeting with the FBI on another matter. During the course of that meeting, Investigator Bahan informed the FBI agent that the FBI may want to investigate case. He heard nothing further from the FBI. Simon Brown, who was Bureau Chief at the time, has no memory of the conversation. There are no records relating to these conversations in any record at DOJ other than the note attached as Exhibit 29.

Although it is not clear when, Attorney Carter's clients stated that they contacted DOJ on two occasions to discuss their case. DOJ has no records of those communications.

F. Findings and Conclusions

Finding #1: DOJ failed to adequately communicate with the Securities Bureau in writing its decision not to file an action in superior court and the reasons, for its decision, and thus failed in its agency counseling obligations. On June 11, 2003, the Securities Bureau asked DOJ to pursue an action in superior court to freeze the assets of FRM. DOJ declined to take that action. Since the Securities Bureau acknowledges that it was only requesting action under the Securities Act, and the Securities Act did not authorize the action requested, the authority to freeze assets did not yet exist. The statutory authority to freeze assets that was authorized by House Bill 816 did not become effective until August 2003. Because the Securities Bureau did not believe any fraudulent activity was ongoing, the Securities Bureau did not provide information to suggest an action was necessary to prevent ongoing fraud or harm. In addition, the administrative hearing was scheduled to occur the following month. Any action that would be filed in superior court would necessarily have required an investigation that could not occur in the time left before the hearing. As such, the relief of appointment of a receiver was not likely to be a viable remedy. An action to enforce an administrative order would have been the more viable action. No such order was ever issued.

Finding #2: DOJ failed to disseminate information within the Department. Multiple contacts within DOJ were not recorded and actions taken not documented. The Civil Bureau had information that FRM was subject to a Securities Bureau action, but that information was not recorded in any database or other document accessible to other lawyers or investigators at DOJ. Second, DOJ received information from an attorney that, in the lawyer's opinion, a financial crime had been committed by FRM. That report was verbally transmitted to the FBI, but there is no formal referral or other documentation to indicate how, when and to whom the information was provided. Because the Civil Bureau's contact with the Securities Bureau was not recorded, the fact that there was a Securities Bureau action pending could not been provided to the FBI. Third, a pair of investors contacted DOJ directly and spoke with someone in the office on two occasions. DOJ has no records of those calls, nor does it have a record of how it responded to the information. Fourth, the DOJ referred five consumer complaints to the Banking Department. DOJ had not established any mechanism with the Banking Department to determine the outcome of Banking's investigations. If the Banking Department determined it had no jurisdiction, and if no other state or federal banking authority had jurisdiction, then the exemptions to the Consumer

Protection Act might not have applied. The lack of coordination between DOJ and Banking, denied DOJ the opportunity to determine if it had jurisdiction to take action

DOJ must improve the manner in which it shares information within the department, and provide meaningful access across its various bureaus to information regarding complaints, pending actions and investigations, rather than allowing each bureau to operate independently of each other. DOJ has made improvements over the years, such as the use of its ProLaw document management software, but those improvements were inadequate at the time of the FRM contacts and remain in need of improvement.

Finding #3: DOJ failed to coordinate and cooperate with other state agencies. Timely and meaningful information sharing is necessary for decisions to be made based on available information. Three different agencies acquired information on FRM but did not share it with each other.

When the Securities Bureau and DOJ were meeting to discuss taking action in superior court, they did not know the Banking Department had by that time conducted two examinations and found significant violations. Banking did not have detailed information that the Securities Bureau had discovered violations of its statutes. Information sharing in this regard should not be based upon the demand of one agency for information available to another agency, but should be available on something more akin to real time data. Thus, if one agency is investigating or contemplating an action against an entity, that agency should have available to it what the State collectively knows about that entity.

DOJ is responsible for providing advice and legal representation in civil matters for all executive branch agencies and investigating and prosecuting major crimes. DOJ should take a leadership role to facilitate information and data sharing among related regulatory agencies and with the DOJ. As is described below in Section X of this Report, a regulatory working group should be formed, and one of its first tasks should be to develop a system of information sharing among agencies.

Finding #4: DOJ failed to provide assistance to the Securities Bureau to correct a failed administrative hearing process. On September 12, 2006, the Securities Bureau informed DOJ that the Bureau's hearing officer had failed to issue an order in two cases, including the FRM case. The amount of time that had passed since the FRM hearing in 2003 may have made resurrecting the process untenable, DOJ has an agency counseling role that should have become involved. In that agency counseling role, DOJ should have worked with the Securities Bureau to evaluate its processes, and installed a proper, functioning administrative hearings process for the Securities Bureau.

X. RECOMMENDATIONS

A. Modify the Exemptions to the Consumer Protection Act

In 2002, the General Court passed House Bill 1429,[88] which exempted from the Consumer Protection Act, RSA 358-A, the following:

> The following transactions shall be exempt from the provisions of [the Consumer Protection Act]:
>
> Trade or commerce that is subject to the jurisdiction of the bank commissioner, the director of securities regulation, the insurance commissioner, the public utilities commission, the financial institutions and insurance regulators of other states, or federal banking or securities regulators who possess the authority to regulate unfair or deceptive trade practices.

This legislation removed from the jurisdiction of the Consumer Bureau activities regulated by Banking, Securities, Insurance and the PUC. As a result of that legislation, consumers affected by individuals or companies subject to these regulators' jurisdiction have no rights under the Consumer Protection Act ("CPA"). In other words, they are entirely dependent upon the regulators to take action, and the right to bring their own private action, as is otherwise authorized under the CPA, is not available. Actions by a regulated business may result in direct consumer harm, but by law, the rights of those consumers to seek redress under the CPA eliminated by the action of the legislature in 2002.

The exemption as originally proposed would have read:

> Conduct in trade or commerce expressly permitted under laws, rules, standards, or regulations promulgated or adopted by any regulatory board or officer acting under statutory authority of this state or of the United States.

Although the exemption to the CPA should be revised, the regulatory agencies should also maintain their statutory authority to enforce consumer protection laws.

B. Establish Consumer Protection Regulatory Working Groups Among Similar Regulating Agencies

Businesses engaged in financial transactions perform functions that cross jurisdictional boundaries, including Banking, Securities and DOJ. As a result, coordination of jurisdictional activities when more than one agency has jurisdiction is essential for pieces of information to be sorted, combined, evaluated and connected. Currently, coordination occurs on an ad hoc basis.

Banking, Securities and DOJ must develop a cooperative relationship. To that end, Banking, Securities and Justice should establish a standing working group that will meet on a regular basis to facilitate information sharing, develop appropriate practices and procedures and for such other reasons as the working group may determine to be appropriate. The Insurance Department should also be involved in light of their jurisdiction over certain financial products. The agency heads should designate the appropriate individuals as members of the standing working group. The first meeting of the working group should be established immediately.

[88] The legislative history of HB 1429 is attached as Exhibit 25.

Among the initial tasks for the working group should be to develop a system of cross-referencing entities directly regulated by Banking, Securities and Insurance. DOJ does not have direct regulatory authority over financial entities, but to the extent not regulated by Banking, Securities or Insurance, DOJ has investigatory and enforcement jurisdiction. The goal should be to develop an electronic system by which entities regulated by the agencies can be searched by name, address or principal owner of the entity, and related entities with overlapping jurisdictions can be flagged.

Once operational, the jurisdictional listing can be used to, among other things, provide notice to other regulating agencies that an audit or exam has been or will be performed, provide opportunities for joint examinations or investigations, and provide notice to one another when disciplinary action is taken against a company (or related company).

Another task for the working group should be to develop a program of cross training field auditors and investigators to better facilitate issue spotting while in the field. If a field investigator identifies an issue of concern within the jurisdiction of another agency, he or she can notify his or her counterparts in the other agencies. Cross-training can involve formal and informal meetings to discuss respective issues, sharing audit and exam plans for how each respective agency approaches audits and exams, and development of tools to help investigators recognize issues subject to jurisdictional cross-over.

C. Require Full Time Hearing Officers

The administrative enforcement actions taken by both the Banking Department and the Securities Bureau exemplify the reason why full time hearing officers are needed to oversee administrative proceedings. Neither administrative proceeding against FRM resulted in a decision. Either one may have caused FRM to close its doors – in the case of the Securities Bureau, as early as 2003, and for the Banking Department, in 2006. Very little or no oversight existed over the enforcement proceedings.

This proposal to create full time hearing officers would be for departments that currently designate staff members to perform this function on an ad hoc basis. The full time hearing officer contemplated in this recommendation would bring agencies with part time hearing officers in line with the practices of agencies such as the Department of Health and Human Services and the Department of Safety, which have existing units staffed with full time hearing officers.

A full time hearing officer would also be in a better position to control proceedings. Once in place, the hearing officer would ensure that cases are reached, dockets will be maintained and proceed in an orderly and professional manner. Unnecessary or inappropriate delay is avoided, and consistent decisions based upon the law would be rendered.

D. Clarify the Exception within Securities Law to Allow Regulation of Investments in Trust Notes Secured by Real Estate

In light of the action taken by the federal SEC, and the Securities Bureau's opinion that it does not have jurisdiction over FRM, the statutes governing the jurisdiction of the New Hampshire Securities Bureau should be expanded to be consistent with the modern Uniform NH Securities Act. Limiting the jurisdiction of the Securities Bureau simply acts to create barriers to protecting New Hampshire's citizens.

E. Establish a Financial Services Unit Within DOJ

Currently, DOJ has lawyers who do work involving bankruptcy, banking, debt recovery, insurance, Medicaid Fraud and white collar crimes. A securities lawyer, under the terms of an MOU similar to MOUs that exist between DOJ/Banking and DOJ/Insurance, should also be added to this unit. A Financial Services Unit within DOJ could combine these resources, providing benefits associated with combining the knowledge and skill of lawyers with expertise in the area of financial prosecution and recovery.[89] This unit should also be staffed with a forensic CPA to provide expert financial analysis. Complex financial crimes require expert forensic services in order to properly understand and investigate financial records. Currently, forensic CPA services must be borrowed, often as a part time effort, from other agencies.

F. Establish Written Recusal Policies

Statewide, all agencies should have a written recusal policy. DOJ should work with the Executive Branch Ethics Committee[90] and the Office of the Governor to develop a statewide minimum recusal policy. Recusal is necessary when the public official has a private interest which may directly or indirectly affect or influence the performance of their duties.[91] In order for the public to have confidence in state government, the public has a right to demand that its public officials be impartial.

"A man cannot serve two masters at the same time, and the public interest must not be jeopardized by the acts of a public official who has a personal financial interest which is, or may be, in conflict with the public interest."[92]

G. Require Separate Legal Entities For Different Regulatory Oversight

It is apparent that the cross regulation of FRM by the Banking and Securities caused confusion among the regulators and the public. Companies doing business in New Hampshire should be limited to performing specific functions that are subject to regulation. Thus, each entity would only perform those functions that it was licensed to do. If, for example, a company

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[89] The resources for this Unit might be found by virtue of staffing previously authorized by the legislature. In response to the Final Report of the committee charged with studying the consumer protection effort in New Hampshire, the legislature proposed to increase the staffing of the Consumer Protection and Antitrust Bureau by authorizing positions for three assistant attorneys general, 2 paralegals and one legal secretary. As originally proposed, the bill appropriated $ 375,000 for the fiscal year ending June 30, 2003. The bill was amended in the House to remove the appropriation, and the positions have never been funded. *See* House Bill 1437 (2002)(Staffing In The Consumer Protection And Antitrust Bureau).

[90] Established in 2006. *See* RSA 21-G:29 –:33.

[91] RSA 21-G:22.

[92] *Atherton v. Concord*, 109 N.H. 164, 165 (1968) (internal quotations and citations omitted).

performed residential mortgage lending subject to banking regulations, and performed commercial lending, not subject to regulation, each function would need to be performed by a separate corporate entity. This restriction would require the creation of separate corporations and books, but would not limit or restrict business operations.

H. Mandate a Regulatory Disclosure Form

Require some form of disclosure to borrowers and investors that identifies what state regulatory authority has jurisdiction over the transaction. The statutory notice could be as simple as a checklist, indicating the transaction is regulated by banking, securities or insurance, or is not subject to any state regulatory oversight. Failure to provide the statutory disclosure would be *prima facie* evidence of a violation.

I. Establish Statewide Centralized Business Lookup Function

A common source of confusion is how citizens obtain information regarding business practices in New Hampshire. Consumers frequently complaint that they have contacted "the State" and learned that the company they are evaluating is "in good standing." Many people recognize that corporations are required to register with the Secretary of State. The Secretary of State has a business lookup function on his website,[93] which tells the consumer whether the business is in good standing *with the Corporation Division of the Secretary of State's Office*. Frequently, consumers stop with that information under the mistaken belief that there are no problems or concerns with that company. In fact, the Corporation Division's status only informs consumers of the status of filings of corporate paperwork, but has no bearing on whether the company has all its appropriate licenses and permits, or whether there are any complaints or enforcement actions pending against a particular company.

Currently, each agency is responsible for the type of information available on its websites. The Consumer Protection Bureau, for example, has established a business lookup function for consumers when they go to DOJ's website.[94] The Banking Department lists public orders issued on its website.[95] The Securities Bureau lists 14 enforcement actions taken since 2002 on its website.[96] All of these are good starts, but none are complete, nor can a consumer go to a single location and get all of this information.

As a simple starting place, every agency should have available on its website an ability to determine (1) what licenses have been issued; (2) the number of complaints filed against a particular company; and (3) the number and nature of any enforcement actions and the status of those actions. Working with DoIT, the State should develop a system whereby all consumer information can be obtained from a single website. Whether that is done by virtue of links to various agency websites, or by way of a single search engine will be a matter of cost and technical complexity that will need to be evaluated by DoIT.

93 https://www.sos.nh.gov/corporate/soskb/csearch.asp.
94 http://www.egov.nh.gov/consumercomplaint/index.asp.
95 http://www.nh.gov/banking/orders.html.
96 http://www.sos.nh.gov/securities/ENFORCACTION.html.

J. <u>Add a Securities Lawyer Position at DOJ</u>

Testimony was presented to the legislature by both DOJ and Securities in 2003 that DOJ has insufficient manpower and expertise to provide timely assistance to the Securities Bureau. Staffing in the Consumer Protection Bureau was recommended by the legislature, but never funded. Currently, the DOJ has MOU's with the Banking Department and Insurance Department to fund positions within the DOJ dedicated to actions on behalf of banking and insurance. This allows the combined benefit of housing a lawyer within the Justice Department, with the support of a professional public law office, to prosecute actions in a coordinated fashion with the agency. Combining the various lawyers within the DOJ has the additional benefit of fostering communication and trust between DOJ and the agencies. This recommendation can be either a stand alone recommendation or be combined with the creation of a Financial Services Unit recommended above.