

MINUTES OF THE MEETING
OF THE
LEGISLATIVE COMMISSION'S SUBCOMMITTEE TO
INVESTIGATE REGULATION OF MORTGAGE INVESTMENTS

June 30, 1998

Las Vegas, Nevada

The first meeting of the Legislative Commission's Subcommittee to Investigate Regulation of Mortgage Investments for the 1997-1998 interim was held on Tuesday, June 30, 1998, at 8 a.m., in Room 4412 of the Grant Sawyer State Office Building, 555 East Washington Avenue, Las Vegas, Nevada. This meeting was video conferenced to Room 4100 of the Legislative Building, 401 South Carson Street, Carson City, Nevada. Pages 2 and 3 contain the "Meeting Notice and Agenda."

SUBCOMMITTEE MEMBERS PRESENT IN LAS VEGAS:

Assemblyman David E. Goldwater, Chairman

Assemblyman Tom Collins

Assemblywoman Barbara K. Cegavske

SUBCOMMITTEE MEMBERS PRESENT IN CARSON CITY:

Senator Bill R. O'Donnell

Senator Raymond C. Shaffer

Senator Randolph J. Townsend

LEGISLATIVE COUNSEL BUREAU (LCB) STAFF PRESENT:

Vance A. Hughey, Senior Research Analyst

Bradley A. Wilkinson, Principal Deputy Legislative Counsel

Ricka Benum, Senior Research Secretary

MEETING NOTICE AND AGENDA

Name of Organization: Legislative Commission's Subcommittee to Investigate Regulation of Mortgage Investments

Date and Time of Meeting: Tuesday, June 30, 1998

8 a.m.

Place of Meeting: Grant Sawyer State Office Building

Room 4412

555 East Washington Avenue

Las Vegas, Nevada

Note: Some members of the committee may be attending the meeting, and other persons may observe the meeting and provide testimony, through a simultaneous video conference conducted at the following location:

Legislative Building

Room 4100

401 South Carson Street

Carson City, Nevada

A G E N D A

I. Opening Remarks and Introductions by the Chairman

Assemblyman David E. Goldwater

II. Review of Past Legislative Studies of Laws, Regulations, and Policies Which Affect Financial Institutions

Vance A. Hughey, Senior Research Analyst, Research Division, Legislative Counsel Bureau

III. Presentation Regarding Regulation of Mortgage Investments and Background Information Concerning the Harley L. Harmon Mortgage Company Case

L. Scott Walshaw, Commissioner, Division of Financial Institutions, Department of Business and Industry

IV. Discussion of Possible Recommendations for Future Legislation

V. Public Testimony

***VI. Adjournment**

*Denotes items on which the subcommittee may take action.

Note: We are pleased to make reasonable accommodations for members of the public who are disabled and wish to attend the meeting. If special arrangements for the meeting are necessary, please notify the Research Division of the Legislative Counsel Bureau, in writing, at the Legislative Building, 401 South Carson Street, Carson City, Nevada 89701-4747, or call Ricka Benum, at 684-6825, as soon as possible.

Notice of this meeting was posted in the following Carson City, Nevada, locations: Blasdel Building, 209 East Musser Street; Capitol Press Corps, Basement, Capitol Building; Carson City Courthouse, 198 North Carson Street; Legislative Building, Room 1214, 401 South Carson Street; and Nevada State Library, 100 Stewart Street. **Notice of this meeting was faxed for posting to the following Las Vegas, Nevada, locations:** Clark County Office, 500 South Grand Central Parkway; and Grant Sawyer State Office Building, 555 East Washington Avenue.

OPENING REMARKS AND INTRODUCTIONS BY THE CHAIRMAN

Chairman Goldwater brought the meeting to order at 8 a.m. He introduced the subcommittee members and staff present in Las Vegas and welcomed those attending in Carson City.

Mr. Goldwater emphasized the importance of the issues relating to mortgage investments and that the subcommittee will examine the state's role in regulating the industry. Both the development and mortgage investment industries are equally crucial to the economic well-being of the state and regulation must ensure a solid, above-board relationship.

The Chairman noted that the focus of the subcommittee is to examine possible imprudent judgment or careless mistakes on behalf of state agency individuals which brought to light statutory weaknesses regarding regulation. The intent of the study is to learn from inadequacies in the statutes, regulations, or the performance of state agencies and not as a punitive investigation of the individuals involved. The nature of the interim study process is to improve the area of concern being reviewed, and amend the methods or policies that have failed in the past. The information provided to the subcommittee will result in recommendations to the 1999 Nevada Legislature for appropriate legislative and regulatory changes and improvements.

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REVIEW OF PAST LEGISLATIVE STUDIES OF LAWS,

REGULATIONS, AND POLICIES WHICH AFFECT FINANCIAL INSTITUTIONS

Vance A. Hughey

Mr. Hughey, Senior Research Analyst, Legislative Counsel Bureau, reviewed two previous legislative interim studies relating to issues specific to the mortgage investment industry. The results of the first study conducted during the 1984 interim are documented in Legislative Counsel Bureau Bulletin No. 85-18, titled, *Study of Laws, Regulations and Policies Which Affect Depository Financial Institutions*, dated August 1984. (Please refer to Exhibit A.) Mr. Hughey informed the subcommittee that:

- The focus of the 1984 interim study was to address concerns that could result from federal deregulation of the industry;
- A primary goal of the subcommittee was to anticipate problems and prepare appropriate legislation for consideration during the 1985 Legislative Session;
- The laws relating to mortgage companies were reviewed in an attempt to determine causes for recent failures of mortgage companies which resulted in losses to Nevada investors; and
- The subcommittee determined the primary cause of mortgage investment losses were the result of the misuse of trust funds.

The 1984 interim subcommittee recommended that title insurance be required for all investment transactions placed through mortgage companies which were not financial institutions. Additionally, title insurance was recommended to be required for all liens secured by real property transferred by mortgage companies.

(Note: The Division of Financial Institutions, Nevada's Department of Business and Industry, was previously under the Department of Commerce.)

Continuing, Mr. Hughey stated that:

Although the 1985 Nevada Legislature considered several pieces of legislation designed to amend the statutes relating to mortgage companies, only one was enacted: Senate Bill 130 (Chapter 663, *Statutes of Nevada 1985*). Among the measure's many provisions, S.B. 130:

- Requires each mortgage company to pay an annual fee for the salary and expenses of a certified public accountant (CPA) employed by the Division of Financial Institutions to review independent audits of mortgage

companies. (Section 2)

- Prohibits the advancing of payments, which allows the Division of Financial Institutions to control the activities of mortgage companies after they have made loans and are servicing them on behalf of the investors or lenders. (Section 3)
- Prohibits the guaranteeing of interest rates. Some mortgage companies apparently were guaranteeing high rates of interest on money held on deposit by the company and paying the interest out of their trust accounts instead of the company's own money. This provision does not prohibit the payment of interest to investors on money being held in an escrow account pending the funding of a loan. Instead, it merely prohibits the guaranteeing of a specific rate of interest. (Section 4)
- Requires that before a person invests money through a mortgage company, he must sign a written statement, made on a form prescribed by the administrator, acknowledging that: (a) the company has explained the nature and risks of investing through the company, including the possibility of default in payment, the fact that payments are not guaranteed, the resulting foreclosure, and the losses that may result; and (b) he is aware that the company is not a depository financial institution. (Section 5)
- Requires that a mortgage company not assign all or part of its interest in a mortgage unless the company obtains title insurance for the mortgaged property and records the assignment with the county recorder. (Section 5.5)
- Requires that all advertisements by mortgage companies be approved by the Division of Financial Institutions prior to their use. (Section 6)
- Requires mortgage companies that hold trust accounts to provide an independent audited financial statement each year as a prerequisite to license renewal. (Section 9)
- Provides for an increase in the license fee for prospective licensees. (Section 9)
- Requires that a mortgage company submit monthly reports of the company's activities to the administrator and requires the administrator to adopt regulations prescribing accounting procedures for mortgage companies handling trust accounts. (Section 10)
- Grants to the administrator authority to impose an administrative fine of up to \$500 for intentional or repeated violation of provisions of *Nevada Revised Statutes* (NRS) 645B.100, "Authorized disciplinary action; grounds," regarding justification for refusing or suspending a mortgage company's license. (Section 11)
- Requires minimum standards of practices for mortgage companies handling trust accounts and clarifies the requirement that a financial institution that carries trust accounts be insured. (Section 12)
- Prohibits a mortgage company from holding money received for funding of a loan in a trust account for longer than a 45-day period before an escrow is open. If a loan package has not been accepted by the investor within the 45-day limit, the money must be returned to the investor within 24 hours. (Section 12)
- Clarifies a clause within the statutes that exempts certain mortgage companies from the provisions of Chapter 645B, "Mortgage Companies" of NRS. (Sections 12 and 16)
- Repeals the fund for mortgage investors. (Section 14)

The second study outlined by Mr. Hughey occurred during the interim of 1986 and culminated in Legislative Counsel Bureau Bulletin No. 87-28, titled, *Study of Laws, Regulations and Policies which Affect Financial Institutions*, dated August 1986. (Please see Exhibit B.) This report highlights the findings and recommendations of the subcommittee in five principal areas:

- Mortgage Companies;
- Banks and Interstate Banking;

- Causes of Failures of Financial Institutions;
- Regulation of Financial Institutions—New Regulation; and
- Miscellaneous.

Mr. Hughey summarized the discussion and findings specific to the topics of mortgage companies and the causes of failures of financial institutions. He pointed out that the 1986 interim subcommittee focused its review primarily on statutory revisions made by the 1985 Nevada Legislature, particularly those under S.B. 130.

- Mortgage companies objected to the high cost they were paying for regulation to remain competitive in the financial market. The administrator of the Division of Financial Institutions concurred and testified that mortgage companies were overburdened. The subcommittee, therefore, recommended eliminating the requirement that only mortgage companies pay the salary and expenses of a CPA for the Division of Financial Institutions. This recommendation was included as a provision in Assembly Bill 9 (Chapter 360, *Statutes of Nevada 1987*) which was enacted by the Nevada Legislature.
- The subcommittee considered the problems that may be caused by some sales representatives of mortgage companies. Although mortgage companies must be licensed, their representatives were virtually unregulated. These representatives could engage in activities damaging to members of the public and to the mortgage companies themselves. The subcommittee recommended licensing sales representatives of mortgage companies in the same manner as real estate agents; that is, tie their licenses to the companies for which they work.
- The subcommittee was urged to prohibit mortgage companies from making collections on loans. However, almost all of the testimony was in opposition and the subcommittee rejected the idea.

Note: The above two provisions were included in bill draft requests but were not enacted by the 1987 Legislature.

Chairman Goldwater pointed out that two members of the current subcommittee, Senators Shaffer and Townsend, served on the interim study subcommittee in 1986.

The remaining recommendations contained in the report which pertain to mortgage companies are clarifications of existing statutes.

Continuing, Mr. Hughey explained the 1986 interim subcommittee also studied the factors that led to the failure of mortgage companies, thrift companies, and other financial institutions. He stated that:

- While some failures may have resulted from poor investments or other factors associated with business cycles, the principal cause of those failures was fraud. The recommendations focused on two areas. First, address specific instances of fraudulent practices. Second, give state regulators the manpower needed to enforce the laws.
- The 1986 subcommittee addressed issues relating to specific instances of fraud.
 1. The first issue related to assignments of beneficial interest of mortgages secured by deeds of trust. In order to prevent fraudulent assignment of the beneficial interest to more than one party or person, the law required mortgage companies to record assignments of its interest in a mortgage and obtain title insurance for the mortgaged property. The subcommittee indicated there was no reason that this requirement should be limited to mortgage companies and recommended requiring title insurance and recording of all assignments of interest in mortgages.
 2. The second issue addressed practices of requests for reconveyances. In order to prevent forgery of signatures on reconveyance documents and to ensure the validity of a beneficiary's request for reconveyance, the subcommittee suggested requiring it to be notarized. If a notarized request for reconveyance was required to be recorded, clear title to property subject to a deed of trust could not be conveyed unless the request is on file. The subcommittee,

therefore, recommended requiring that a request for reconveyance of secured property be notarized and recorded and that the notary public not have a financial interest in the reconveyance.

Note: The two recommendations outlined above were not enacted by the 1987 Nevada Legislature.

Mr. Hughey noted that the report indicated the best way to prevent fraud was to improve the ability of state regulators to detect violations of law and enforce those laws.

- A provision of S.B. 130 from the 1985 Session required mortgage companies to fund a full-time CPA within the Division of Financial Institutions to audit mortgage companies that maintain trust accounts. The administrator explained to the subcommittee problems of implementing the requirement. Information was provided to the subcommittee that indicated that just two mortgage companies would be assessed with over half the cost of hiring the CPA. While S.B. 130 required the Division to employ a CPA to review mortgage companies, the subcommittee agreed with the administrator that an accountant would be valuable to the Division in the regulation of all financial institutions. The subcommittee recommended creating a CPA position in the Division of Financial Institutions and not limiting the scope of work just to mortgage companies. This recommendation was included as a provision in Assembly Bill 9 (Chapter 360, *Statutes of Nevada 1987*) which was enacted by the Nevada Legislature.
- The 1986 interim subcommittee recommended authorizing additional personnel for the Division of Financial Institutions without increasing the fees paid by financial institutions. The final report of the subcommittee indicated testimony which established that:
 1. Both regulators and the regulated institutions urged expansion of the Division of Financial Institutions;
 - 2 The Division raised almost twice as much money as it spent and the excess funds were used for other purposes; and
 3. Cutbacks at the federal level have shifted more responsibility for regulation to the states, and it was essential that regulators be provided with sufficient personnel to examine the state's financial institutions.

Mr. Hughey noted the subcommittee's intent to correspond by memorandum to the Senate Committee on Finance and the Assembly Committee on Ways and Means urging that the staff of the Division of Financial Institutions be expanded.

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PRESENTATION REGARDING REGULATION OF
MORTGAGE INVESTMENTS AND BACKGROUND INFORMATION
CONCERNING THE HARLEY L. HARMON MORTGAGE COMPANY CASE
AND
DISCUSSION OF POSSIBLE RECOMMENDATIONS FOR FUTURE LEGISLATION

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L. Scott Walshaw

Mr. Walshaw, Commissioner, Division of Financial Institutions, Department of Business and Industry, provided an overview of the methods used by the Division to supervise investments and loans secured by real property. In addition to other information, Mr. Walshaw offered details focusing on the following regulatory policies and procedures:

- The Division supervises mortgage investments arranged by companies subject to licensure under Chapter 645B of NRS. Contained in the statutes are certain provisions that exempt several types of entities and mortgage company operators from the requirement of obtaining a mortgage company license.
- Briefly defined, a mortgage banker is an entity that is approved as a lending institution by the Federal Housing Administration (FHA), Federal National Mortgage Association (FNMA), and the United States Department of Housing and Urban Development (HUD), as well as an approved lender of the U.S. Veterans Administration (VA).
- Nevada currently has over 300 mortgage companies that are exempt from the requirement of a mortgage banker's license. There are companies that are subsidiaries or direct loan production offices of banks or other financial institutions that are insured by the Federal Government, which are not required to have a license.
- There are two types of classifications of mortgage company licensees: (1) those that handle the money of others, and (2) those that do not handle money of other entities or persons. The majority of the companies licensed in Nevada are considered loan brokers, described as a company which arranges financing between a borrower and a lending source.
- The other form of operation involves a company that solicits private investor funds for the purpose of funding loans originated by the mortgage licensee. The private investor can choose to have their money with the licensee, or the mortgage company can arrange to have the funds handled by an independent third party, such as a licensed escrow or title company.

Clarifying an earlier question from the Chairman, Mr. Walshaw explained that Chapter 692A, "Title Insurance," of NRS specifically regulates the escrow functions of a title insurer, and is subject to the oversight of the Commissioner, Division of Insurance, Department of Business and Industry. Further, he explained that Chapter 645A, "Real Estate Brokers and Salesmen; Qualified Intermediaries," of NRS was brought under the purview of the Division of Financial Institutions following the restructuring of state agencies by the 1991 Legislative Session.

Mr. Walshaw provided details which addressed issues concerning solicitations of private investor funds and outlined several requirements that must be followed by mortgage investment companies in conjunction with the handling of money of other persons. He explained that:

- The books and records of the mortgage company are subject to the annual requirement of an audited financial statement prepared by an independent CPA, to be submitted to the Division of Financial Institutions within 60 days of the close of the end of the licensee's fiscal year;
- The mortgage companies handling the funds of others are prohibited from: (1) advancing payments to investors on loans which are in default; and (2) holding investor-solicited money for the purpose of funding loans for more than 45 days without opening a valid escrow;
- The Division gives administrative priority to examination of mortgage investment companies that handle funds from solicited investors; and
- There are general requirements for all licensees to provide disclosure concerning the risks associated with these types of investments and providing certain minimal loan documents to each borrower and lender involved in the transaction.

It was specifically noted by Mr. Walshaw that the investor has the option to waive receipt of such documentation, and has the right to contractually permit the licensee to make investment decisions on their behalf.

Chairman Goldwater questioned (1) whether Mr. Walshaw, as Commissioner, has the statutory authority to comment on the quality of the documentation or financial statements submitted to his office; and (2) whether the Division has the ability to issue any type of judgment in regard to the manner or type of business or solicitations conducted by the mortgage investment company.

In response, Mr. Walshaw indicated that in many instances the financial statement is rejected, or supplemental questions must be satisfied following review by the Division's CPA. The CPA's review often has resulted in

situations where persons have been referred to the Nevada State Board of Accountancy for disciplinary action. Further, the Division's examiners do not evaluate or offer subjective judgment as to the caliber or quality of the business conducted by the mortgage investment company. A determination is made only to ensure that the investor has been provided the opportunity, as required by regulation and/or statute, to evaluate the type of investment being offered and enable them to make an informed decision.

Mr. Walshaw clarified his comments by stating that the mortgage investment business in question involves high risk situations which account for the maximum rate of return. Loans are often approved for parties who may not have the ability or inclination to qualify for financial allowances through normal channels or standard lending institutions.

In response to an inquiry pertaining to the 60-day requirement to submit financial statements, Mr. Walshaw indicated that Nevada's statutes contain provisions for reasonable extensions to be granted to the mortgage company licensees. He stated that it is routine practice of the Division to grant extensions on a regular basis, and this procedure is monitored by the Division's CPA.

Chairman Goldwater summarized statements contained in a 1993 legislative audit report on the Division of Financial Institutions. He questioned whether the recommendations pertaining to the regulation of escrow companies had been successfully implemented.

Mr. Walshaw responded affirmatively and highlighted several factors contained in the Division's response to the legislative audit. Among other concerns, he addressed the issues that occurred when the Division of Financial Institutions inherited oversight of licensed escrow companies. He stated that:

- The majority of the escrow companies had never been examined or reviewed at the time the duties of regulation were assumed by the Division;
- Following the initial audits and examination of the escrow companies, approximately a half dozen entities were forced to close by the Division;
- The representatives maintained that the problems outlined in the 1993 legislative audit and the subsequent losses from escrow company closures, were not the fault of the Division of Financial Institutions but rather, the inherited circumstances from the previous regulatory procedures of the Real Estate Division, Department of Business and Industry; and
- Although escrow companies were required to be licensed, it was not inherently clear that the necessary reviews were being performed prior to oversight by the Division of Financial Institutions.

Continuing, Mr. Walshaw's comments focused on the overview of the Harley L. Harmon Mortgage Company case, and the involvement of the Division of Financial Institutions. He informed the committee that:

- The Division performed an examination of Harley L. Harmon Mortgage Company as of November 30, 1996, and a report was issued in January of 1997;
- The report was reviewed by Burns Baker, Deputy Commissioner, Division of Financial Institutions, and culminated in an interoffice memorandum dated February 21, 1997, citing numerous problems with operations of the mortgage company;
- A subsequent meeting was held to develop a course of action to address the issues of concern and occurrences documented within the Harley L. Harmon Mortgage Company. Attending that meeting were Mr. Burns; Douglas E. Walther, Deputy Attorney General, representing the Division; and Mr. Walshaw. They mutually agreed that: (1) there was a lack of substantiating evidence; (2) there was need for further investigation of the Harley L. Harmon Mortgage Company; and (3) further review would determine whether the nonperformance of loans were the result of misconduct on the part of representatives of the mortgage company; and
- Following an administrative investigative hearing on March 6, 1997, during which Mr. Harmon was questioned under oath, representatives of the Division determined that: (1) Mr. Harmon's father, the previous operator/owner of the mortgage company should be approached for the purpose of obtaining additional documentation and information; (2) there should be voluntary removal of Mr. Harmon as operator of the

mortgage company; and (3) there was evidence of need for a voluntary receivership to replace Mr. Harmon to conduct the operations of the mortgage company.

It was noted by Mr. Walshaw that in late March 1997, the Deputy Attorney General of the Division presented the above suggestions by telephone conference call, to both Mr. Harmon and his legal counsel. A written rejection of the proposal for a voluntary receivership proposal was subsequently received along with the suggestion that a Harmon employee be made responsible for the problem loans referenced in the Division's report.

Mr. Walshaw stated that based on the rejection of the proposal, the representatives of the Division:

- Concluded that the licensee would resist any attempt to remove or revoke the mortgage company's license;
- Determined the necessity for a full investigation to determine whether or not the actions of Mr. Harmon contributed to the problems with the loans documented in the examination of the company;
- Prepared and served subpoenas during the months May through June 1997, for construction-control account records, requested further records of specific loan transactions, and scheduled a second investigative hearing in late July 1997, at which Mr. Harmon was to produce the requested documentation;
- Held discussions during July and August 1997, regarding the results of the second hearing, the status of the investigation, and outlined the failure of Mr. Harmon to comply with the request for records; and
- During the same approximate time, completed a summary of results of the investigation, and made the determination to provide the licensee the opportunity to produce missing documentation to address the concerns and avoid revocation action.

The following are the actions as outlined by Mr. Walshaw that were taken against the Harley L. Harmon Mortgage Company:

- In the period between August and October 1997 a review of the documentation produced by Mr. Harmon was concluded. It was determined by the Division to proceed with administrative action and Nevada's Office of the Attorney General was to prepare: (1) a Complaint for Revocation of the License; (2) a Complaint for Injunctive Relief; and (3) a Motion for Preliminary Injunction against the licensee, in that order;
- Discussions were held in early November 1997 with the legal counsel representing the licensee regarding the surrender of the actual license and a Stipulation for a Preliminary Injunction; and
- In December 1997 a Revocation Action was filed and subsequently a receiver was appointed for the Harley L. Harmon Mortgage Company.

The following statements represent a summary of the responses provided by Mr. Walshaw during the lengthy discussion that ensued and questions raised by the subcommittee members.

- In response to Senator O'Donnell, Mr. Walshaw stated that the appropriate law enforcement agencies are investigating Mr. Harmon's operation of the mortgage company. However, he was not aware of any civil actions pending which involve Mr. Harmon. The Division is cooperating with the appropriate enforcement agencies to the extent of producing the necessary records.
- Mr. Walshaw estimated that in early August 1997 it was decided by the Division representatives that if the licensee did not provide the documentation requested to refute the preliminary evidence, the Division would proceed with the revocation action.
- Further, Mr. Walshaw indicated that as he understood the situation, there was a question as to whether the problems experienced by the mortgage company were related to economic circumstances or the result of the manner in which Mr. Harmon conducted the affairs of the company. The Division did not have a complete compilation of the evidence in order to substantiate beyond a doubt, that an action for revocation action was necessary.

Mr. Walther, identified previously, was requested to respond to questions posed by the subcommittee in addition to Mr. Walshaw's account of the time frames involved. Regarding the number of months required to accomplish the appointment of a receiver to oversee the operation of the Harley L. Harmon Mortgage Company, Mr. Walther offered the comments as summarized below.

- Due in part to the complexity of the case, the process of drafting a complaint and taking the appropriate legal action could not be accomplished in a matter of weeks. Prior to the July 1997 hearing, the complaint was already in the form of a rough draft. Previously, the Division had been focusing on specific issues of concern and following the July hearing a multitude of additional questionable issues were raised, subsequently requiring additional requests for information from Mr. Harmon.
- Detrimental aspects that contributed to delays in the case and in obtaining the proper documentation required to substantiate successful legal arguments were:
 1. The lack of maintenance of proper records by the mortgage company. The specific records and copies of those records that the mortgage company should have maintained in its ordinary course of business, according to applicable laws and the issues that were being scrutinized were not immediately available. During questioning of Mr. Harmon, testimony often focused on explanations regarding documents that had been reviewed by the Division, but with no substantiating documentation or record available as normally should have been available.
 2. Approximately mid-September 1997, Mr. Harmon provided the Division a large volume of documentation and records that required extensive analysis to determine their effect, if any, on the loan documentation already reviewed by the staff of the Division.

Chairman Goldwater asked that Mr. Walther be specific in recounting the dates, the exact records requested, and the dates documents were provided to the Division to assist the subcommittee in understanding the procedures that occurred during the lengthy Harmon investigation.

Mr. Walther continued to provide an account of the investigation of the Harley L. Harmon Mortgage Company. The following is a summary of Mr. Walther's comments.

- Referring to the issue of documentation, it was noted that the investigation brought forth instances where investors executed broadly written Powers of Attorney, granting the Harley L. Harmon Mortgage Company broad discretions to make decisions regarding the loan funds belonging to investors.
- There were instances where investors received improper accounting or documentation of their loan accounts, and in some cases, investors did not receive any substantiating records pertaining to their loans. Also, there was evidence of numerous instances whereby investors had waived their right to certain documentation involving their investments. It was pointed out that many of the loans involved up to 60 or 80 investors, and with the poor record keeping on the part of the mortgage company, many Division hours were required to determine the loans that were essentially in the worst condition.
- The Division eventually requested that Mr. Harmon provide every waiver executed by any investor associated with his company. It was determined from Mr. Harmon's testimony that the possibility existed that many waivers were lost or misfiled, and there was the likelihood that several investors never executed documentation waivers prior to finalizing the loans.
- The initial concern surrounding the Harley L. Harmon Mortgage Company was the lack of record keeping. Following the first hearings, the Division's representatives realized the severity of the condition of supporting documents and the lack of records of the loan files.
- Another area of initial concern focused on loan payoffs. Mr. Harmon conceded that certain investors received loan payoffs disproportionate to their actual beneficial interest in the loan. There were various explanations

regarding the circumstances for the reasons behind the discrepancies in the distribution of funds.

Chairman Goldwater specifically asked Mr. Walshaw if examiners of the Division were aware that investors were receiving loan payoffs disproportionate to their beneficial interests. Mr. Walshaw indicated that the Division suspected the practice was occurring. He further stressed the importance of obtaining the evidence to prove the loan payoff discrepancies prior to filing charges so that the allegations could be substantiated if the case went to court. Mr. Walshaw testified that the loan practices were generally admitted to by Mr. Harmon and he pointed out that during at least one investigative hearing, Mr. Harmon's counsel discussed whether or not the practice of disproportionate payoffs were prohibited by Nevada law.

Assemblyman Collins questioned whether the Division is obligated by statute to offer a voluntary receivership to a mortgage company which is experiencing the types of problems documented in the Harmon case.

Mr. Walshaw replied the Division is not statutorily bound to such a proposition. However, the suggestion was viewed as an immediate resolution to the problems they suspected were occurring with loan procedures of the Harley L. Harmon Mortgage Company.

In response to questions from Senator Townsend, Mr. Walther clarified that:

- Mr. Harmon's testimony was not clear as to the methods used to make disproportionate loan payoffs;
- The Division could not establish how the practice of inaccurate loan payoffs was being accomplished, or whether or not there was actual or implied consent from the investors involved;
- The existence of the legally questionable and broadly written limited Powers of Attorney served to further "cloud" the issue; and
- The Division found the legal research to establish validity of the limited Powers of Attorney difficult and time-consuming.

Further, Mr. Walther commented that during the course of the investigation, there was the "basic idea" as to what Mr. Harmon was admitting, but investigators were not clear on his motivation, or to what degree the practice was occurring. Ultimately, the Division was able to establish without doubt, that Mr. Harmon's actions were contrary to best interest of the investors.

Senator Townsend inquired whether there is a standard industry practice established in regard to loan payoffs, or if mortgage companies are: (1) allowed to categorically reinvest or keep "rolling over" an investor's money without specific consent for each payoff occurrence; or (2) required to notify the investor for specific instructions as to how to handle the funds.

It was indicated that no standard or normal course of action exists and that each mortgage company licensee may respond differently to that type of inquiry.

The following are summaries of additional responses to subcommittee questions from Messrs. Walshaw and Walther, in regard to the investigation:

- All the investors involved were not subpoenaed, but some were interviewed once a "paper trail" had been established. Those interviewed were selected on "a sampling-type basis," and asked to either confirm or rebut certain explanations given to them by Mr. Harmon pertaining to their investments.
- Responses from many investors were "not particularly helpful" to the investigation and the impression given to the investigators was that unquestionable trust was placed in Mr. Harmon. In most instances: (1) the investors did not have copies of documents they had executed; and (2) there was indication the investors did not understand or know the purpose for many documents they had executed.

Senator Townsend interjected that the documentation possessed in July 1997 should have been sufficient indication for decisive and immediate action on the part of representatives of the Division. The general understanding of the industry is that if one investor is overpaid it indicates that another investor must be underpaid and should have

demonstrated to the Division that these types of business practices should have been halted.

- Mr. Harmon's counsel initially argued that the loan payoff procedures were not prohibited by statute and an attempt made to suggest the methods used by Mr. Harmon were appropriate and justified. However, the Division was assured that the practice of disproportionate loan payoffs had been discontinued since the time of the initial examination in 1996. Further, there was no evidence that the practice was ongoing or had reoccurred and did not need to be immediately addressed by the Division.
- The investigation and search for proper documentation was complicated by many loan payoffs that were disbursed through title companies and construction-control firms. Therefore, it was necessary for investigators to subpoena the records of several other companies.
- It was necessary for the Division to trace loan funds from the point of initial escrows in order to establish: (1) allegations that investor money was used for purposes other than the intended reason it was entrusted to Mr. Harmon; and (2) evidence that the disposition of loan proceeds were being applied to other or unauthorized loan accounts.

Neither Mr. Walshaw nor Mr. Walther could provide Senator Townsend the exact date the Division substantiated that loan proceeds were being applied to different loan accounts or used for other purposes.

Senator Townsend questioned whether the Division had the legal authority in July 1997 to suspend the license and halt the business practices of the Harley L. Harmon Mortgage Company.

Mr. Walther commented that although the Division had a considerable amount of information at the time, the analysis necessary to establish a pattern and to build a case against the mortgage company was not sufficient. He stressed that it was necessary for the evidence and information to be compiled in such a manner to effectively substantiate any charges that may be filed.

In addition, Mr. Walshaw pointed out that in retrospect the decisions made by the Division during the investigation may appear now to have been easy to make. During such time when the evidence was being compiled, decisions were not as clear as they appear to be at present. The Division made judgments based on the information that was available at the time with the caveat that anytime an action is taken against a company that handles the money of others, it creates a potential to ruin a business or create a "financial run."

The following summaries of responses were to questions from the subcommittee members.

- The investigation concluded from the four loans that were examined by the Division that documentation pertaining to disclosures required under NRS 645B.185 "Acknowledgment by investor of certain facts," were either incomplete or nonexistent.
- The Division representatives could not estimate the number of total investors involved, although the investigation focused on four of approximately 50 active loans. However, the number of investors listed by the receiver currently overseeing the operations of the Harley L. Harmon Mortgage Company has been listed as approximately 600. It was noted that all inquiries regarding current information on the disposition of funds or action on claims from individual investors would need to be addressed by the receiver for response.
- There have been no procedural changes to the methods in which investigations are handled by the Division since the occurrence of investor losses associated with the Harley L. Harmon Mortgage Company.
- The Division of Financial Institutions currently has 14 examiners and a total staff of 25.
- There has not been a specific notification or referral to the Office of the Attorney General regarding intervening or possible criminal prosecution concerning the Harley L. Harmon Mortgage Company case.

Chairman Goldwater questioned whether remedies exist to notify investors if a mortgage's business practices are being investigated or scrutinized by the Division of Financial Institutions. Secondly, he asked if any avenues are available to the public to "somehow warn potential investors" that a specific mortgage company has been investigated by the Division.

Senator O'Donnell suggested the possibility of authorizing the Division of Financial Institutions to rate mortgage companies.

The Chairman announced his intention to forward every question presented to the subcommittee to the Division of Financial Institutions with a request for response.

PUBLIC TESTIMONY

Dan Gray

Mr. Gray, an investor in the Harley L. Harmon Mortgage Company, summarized his encounter and subsequent exchanges over a ten-month period with the Las Vegas office of the Division of Financial Institutions. Mr. Gray contends he was treated in a rude, unprofessional manner after bringing investor losses and possible fraudulent business practices to the attention of the Division, as well as providing the agency an abundance of documentation to support charges against Mr. Harmon.

Focusing on the events that occurred during 1997, Mr. Gray outlined encounters with personnel from the Division and the Office of the Attorney General. In addition to other comments, Mr. Gray testified that:

- The Division placed blame for the loss of funds on investors for not being more astute and discerning the poor business practices of the mortgage company;
- The Division representatives indicated they did not have the responsibility to file charges against the Mr. Harmon or to take action against the Harmon L. Harley Mortgage Company;
- There was an awareness on the part of the Division that the mortgage company was not procuring title insurance as required by statute;
- The Division permitted Mr. Harmon to set the pace of the investigation, while contending there was insufficient evidence on which to base a case regarding mortgage company violations;
- The Division allowed Mr. Harmon to remain in business, continue to advertise for the purpose of bringing in new investors, and was permitted to continue inadequate record keeping; and
- There was documentation in Division files that substantiates that Mr. Harmon told examiners that on the advice of counsel he created the Harley L. Harmon Mortgage Company, Inc., for the purpose of conducting further mortgage activities, while "leaving all problem loans and liability" under the previous mortgage company_Harley Harmon Mortgage Company, Inc.

(Please refer to Exhibit D for the documents submitted by Mr. Gray.)

Mr. Gray recommended immediate suspension of any licenses of Mr. Harmon and the Harley L. Harmon Mortgage Company, and that a press release be issued to effectively serve notice to all investors.

Chairman Goldwater requested the Office of the Attorney General and Division of Financial Institutions to provide him with explanations why the accusations and evidence provided by Mr. Gray were ignored. Secondly, he asked why Mr. Gray did not receive any type of response from the Division.

Burns Baker

Mr. Baker, previously identified, responded to inquiries from the Chairman regarding his observations and subsequent recommendations submitted in the memorandums referenced as Exhibits C and D of these minutes. He indicated that during a meeting between representatives of the Division and the Office of the Attorney General there was agreement regarding the issue of insufficient evidence, and the decision not to move for suspension of the license. Mr. Baker testified it was his suggestion to propose the plan for a voluntarily receivership to Mr. Harmon.

Responding to additional questions Mr. Baker explained that previous actions or punitive measures taken by the Division had been overturned, primarily due to lack of evidence. The representatives of the Division wanted to ensure there was proof to corroborate the violations. Continuing, Mr. Baker highlighted the occurrence of one loan in which eight investors were given second deeds of trust in lieu of receiving payoffs on their investments.

Chairman Goldwater expressed displeasure with the procedures followed by the Division of Financial Institutions insofar as the approach used in investigating the Harley L. Harmon Mortgage Company. He cited the importance for the subcommittee to be clear on the methods used to regulate the state's financial business.

Several subcommittee members voiced criticism regarding the procedures used by the Division to procure the records, which are specifically required by statute, and the amount of time Mr. Harmon was allotted to provide the records.

Chairman Goldwater requested that Mr. Walther: (1) brief the subcommittee on any legal action that has been filed recently; (2) provide an update regarding ongoing litigation against Mr. Harmon; and (3) report on the disposition of loan funds and the current status of the receivership process.

In response, Mr. Walther stated there is agreement between the Division and the receiver to file a legal stipulation for the purpose of requiring a status hearing in open court. The intent is to submit a written report citing the plan for liquidation of the Harley L. Harmon Mortgage Company and its investments. An update on all actions that have been taken will be provided by the receiver at the status hearing.

A pleading has been filed with the court to liquidate two of the loans in question at the request of the receiver. The Division requested that disposition of the proceeds of the above be held until the court could consider a comprehensive plan for the liquidation of the entire receivership.

A brief discussion ensued which focused on the issue of "pooling" the entire assets of the receivership for the purpose of allowing the appointed receiver to essentially view the investors as a group rather than having individual beneficial interests. Mr. Walther indicated his position on behalf of the Division will be to file a detailed legal brief requesting that the court decide if the suggested proposal of "pooling the assets" is an equitable resolution to all the investors. He pointed out that there are alternate proposals.

Chairman Goldwater encouraged the Division to work towards achieving a swift resolution regarding the disbursement of funds, and the liquidation of assets as the process of the receivership moves forward. Noting that the circumstances and legal proceedings involving the Harley L. Harmon Mortgage Company will be closely monitored for updated reports to the subcommittee. The Chairman reiterated his intention to request from the Office of the Attorney General and the Division of Financial Institutions detailed acknowledgments and responses to questions from investors and the subcommittee members. He noted that the responses will also be discussed during future meetings.

There being no further committee business, the Chairman adjourned the meeting at 12:05 p.m.

Respectfully submitted,

Ricka Benum

Senior Research Secretary

APPROVED BY:

Assemblyman David E. Goldwater, Chairman

Date: _____

LIST OF EXHIBITS

Exhibit A is a copy of Legislative Counsel Bureau (LCB) Bulletin No. 85-18, titled, *Study of Laws, Regulations and Policies Which Affect Depository Financial Institutions*, dated August 1984.

Exhibit B is a copy of Legislative Counsel Bureau Bulletin No. 87-28 titled "*Study of Laws, Regulations and Policies which Affect Financial Institutions*", dated August 1986.

Exhibit C is a memorandum to L. Scott Walshaw, from Burns Baker, dated February 21, 1997, titled "Harley L. Harmon Mortgage Company (Inc) Formerly Harley Harmon Mortgage Company, Inc., Examination as of November 30, 1996. " (Note: This document was labeled as Exhibit A by Mr. Gray for purposes of his testimony.)

Exhibit D is a copy of a memorandum, to Doug Walther, Senior Deputy Attorney General, from Burns Baker, dated September 4, 1997, titled "Harley Harmon Mortgage Co., and Harley L. Harmon Mortgage Co." (Note: This document was labeled as Exhibit B by Mr. Gray for purposes of his testimony.)

Exhibit E is a compilation of advertisements pertaining to the Harley L. Harmon Mortgage Company submitted by Dan Gray.

Exhibit F contains copies of documents pertaining to mortgage investment issues. This information was provided by Senator Valerie Wiener, via facsimile, to Vance A. Hughey, Senior Research Analyst, Research Division, LCB.

Exhibit G is the Attendance Record for this meeting.

Copies of the materials distributed in the meeting are on file in the Research Library of the Legislative Counsel Bureau, Carson City, Nevada. The library may be contacted at (702) 684-6827.