Recent Enforcement Actions Involving the Sale of Variable Annuities

Commission Actions

In re Raymond A. Parkins, Jr. (SEC Release No. 33-8055 (January 18, 2002)): The Commission found that Parkins, an investment adviser and agent registered in Florida, induced his advisory clients to switch their variable annuities by providing them with unfounded, false and misleading justifications for the switches, and by misrepresenting or failing to inform his clients of the sales charges associated with the switches. As a result of Parkins' fraudulent conduct, his clients incurred unnecessary sales charges, and in some cases lost a portion of their investment principal, while Parkins received commissions of more than $210,000 for the transactions. The Commission censured Parkins, barred him from the industry with a right to reapply after two years, and ordered him to pay disgorgement in the amount of $214,656, plus prejudgment interest.

Securities and Exchange Commission v. Gregory P. Waldon (No.S-02-1395 (E.D. Cal.)), ***In the Matter of Gregory P. Waldon***, Exchange Act Release No. 48419 (August 29, 2003): The Commission found that Waldon defrauded customers in connection with the sales of variable annuities, by soliciting them to switch out of investments they already had in variable annuities and use the funds to purchase new variable annuities, incurring costs and expenses in the process. The complaint alleged that Waldon acted with scienter, as he profited from the sales while the customers incurred increased costs or risks from the transactions, without offsetting benefits. The complaint further alleged that Waldon made material misrepresentations to customers, and omitted material information important to the customers, with respect to certain sales. The SEC found that Waldon recommended approximately 57 such switches between 1998 and 2001 in which his customers, most of whom were at least 70 years old and retired, received no economic benefit or lost money and incurred $200,000 in needless transaction costs while Waldon received approximately $275,000 in commissions. The Commission barred Waldon from the industry, with a right to reapply after three years.

In the Matter of Donna N. Morehead, (Exchange Act Release No. 46121 (June 26, 2002)): The Commission found that Waldon's supervisor, Donna Morehead, failed reasonably to supervise Waldon. The Commission found Morehead to have failed effectively to carry out her responsibility to review Waldon's transactions, including variable annuity switches, with a view toward detecting and preventing securities law violations. When confronted with red flags, Morehead relied upon the information provided by the registered representative, including verbal explanations that were demonstrably false. The Commission found that if Morehead had obtained other, objective information regarding the customers' accounts, including the account statements, the registered representative's false justifications would have been exposed. In a settled Order, the Commission barred Morehead for one year from acting in a supervisory capacity with any broker-dealer, and ordered her to pay a civil money penalty of $10,000.

NASD Actions

***Prudential Securities, Inc*.** (Case Number C05010005 (February 15, 2001)): The firm was sanctioned for failing to prepare or maintain forms that were called for in its written supervisory procedures. For example, the firm required that an exchange form and worksheet be completed in connection with replacement activity, but in a number of instances the forms were missing. The firm agreed to a censure and fine of $10,000.

Allmerica Investments, Inc. (Case Number C05010004 (February 15, 2001)): The firm was sanctioned for failing to design new account documents sufficient to enable principals to effectively review and approve the suitability of variable annuity transactions. More specifically, the firm's account documents provided two options for investment objectives: "retirement" or "other." This information was not sufficient to enable principals to determine customer investment objectives. The firm agreed to a censure and fine of $15,000.

Lutheran Brotherhood Securities Corp. (Case Number C05010003 (February 15, 2001)): The firm was sanctioned for failing to capture customer investment objectives in its account documentation. Further, the firm's written supervisory procedures did not require the gathering of customer objectives, but instead encouraged the brokers to obtain this information. The firm's procedures did not require a review of the allocation of premium payments to the underlying funds. The firm agreed to a censure and fine of $25,000.

First Union Brokerage Services, Inc. (Case Number C05010010 (February 15, 2001)): The firm's written supervisory procedures were found deficient in that they did not adequately address the review of variable annuity transactions, did not require supervisory review of premium allocations to the underlying funds and did not address how certain delegated responsibilities were to be supervised. The firm also failed to obtain required disclosure forms, failed to evidence the delivery of prospectuses and failed to document customer suitability information in a number of instances. The firm agreed to a censure and fine of $32,500 (including $5,000 of disgorgement).

American United Life Insurance Company (Case Number C05010011 (February 15, 2001)): The firm was sanctioned for using material in the promotion of variable annuities for tax-qualified plans that failed to disclose that the variable annuity provides no additional tax benefit. The material also failed to clearly identify the underlying funds within the variable annuity. The firm failed to develop written procedures for the review and approval of advertising and sales literature. The firm agreed to a censure and fine of $25,000.

Ralph C. Evans (Case Number C05010009 (February 15, 2001)): Evans was censured for making an unsuitable recommendation of a variable annuity contract to a public customer. The annuity was purchased in a trust account, partially on margin and partially with the proceeds from the liquidation of class B mutual fund shares. Evans did not perform an analysis to determine whether the customer's holding period would be long enough to outweigh the higher expenses of the product and the fees for liquidating the class B mutual fund shares. Evans consented to findings that the transaction was unsuitable and agreed to a censure and fine of $10,000 and restitution of $20,000.

CUNA Brokerage Services, Inc**.** (Case Number C05010054 (December 5, 2001)): The firm was sanctioned for failing to establish and enforce adequate written supervisory procedures covering its variable product business. The procedures failed to adequately address review and approval of transactions, suitability of recommendations, training and supervision of representatives, and customer complaint handling. Additionally, the firm failed to maintain records that information was obtained in connection with customer suitability and exchange transactions. Three individuals, including two representatives and the compliance officer were also charged. One was charged with an unsuitable recommendation of a variable annuity to a customer. The second representative was charged with misrepresentation in that he failed to disclose that the annuity was subject to IRS penalties if the earnings were withdrawn before the customer was age 59 ½. The firm agreed to a censure and fine of $100,000, of which $25,000 was assessed jointly and severally against the compliance officer. The broker charged with the unsuitable recommendation was fined $5,000 and suspended for 10 days. The broker charged with misrepresentation was fined $2,500 and suspended for 5 days.

Mutual Service Corp. (Case Number C05010053 (December 5, 2001)): The firm was sanctioned for failing to establish and maintain adequate written supervisory procedures covering its variable product business. Specific areas of deficiency included: principal review and approval of variable life insurance transactions, monitoring of surrenders and cancellations, use of exception reports, supervision by home office principals of variable product transactions by OSJ managers, and supervisory review of the allocation of premium payments to the underlying funds. The firm agreed to a censure and fine of $35,000.

Tower Square Securities, Inc. (Case Number C05020003 (January 18, 2002)): The firm was sanctioned for failing to establish and maintain adequate written supervisory procedures related to monitoring branch office inspections, variable annuity and life insurance suitability reviews and registration of employees. In addition, complaints were filed against a former registered representative with Tower, Kevin B. Dermody, and his business partner, Randall J. Veselik. The three enforcement actions involve the mishandling of the investment portfolio of the school system's deferred compensation retirement plan. Proceeds of an annuity liquidation, along with additional plan contributions, were used by Dermody to purchase securities and insurance products including investment contracts issued by a company organized by Dermody and Veselik. The majority of plan funds invested with Dermody and Veselik's company was lost through speculative trading. Tower Square Securities was fined $200,000 and directed it to make $4.3 million in restitution to the Jefferson Parish, (Louisiana) Public School System's employees deferred compensation plan.

Conseco Securities, Inc. (Case Number C9B020058 (August 12, 2002)): The firm was sanctioned for failing to establish and maintain adequate written supervisory systems and failing to maintain adequate documentation related to customer suitability information. The firm's procedures failed to address: review and approval of variable annuity transactions, collection and maintenance of suitability information, supervision of annuity sales, and surveillance of transactions for patterns of cancellations or surrenders. The compliance officer failed to enforce firm procedures when he was required to do so. The firm agreed to a censure and a fine of $65,000, of which $10,000 was assessed jointly and severally against the firm's compliance officer.

American Express Financial Advisors (Case Number CAF020057 (December 4, 2002)): The firm was sanctioned for omitting material facts when selling variable annuities into tax-qualified plans. In making some sales, registered representatives failed to disclose that variable annuities do not provide the benefit or advantage of tax-deferred earnings when purchased in qualified plans. In addition, in certain instances firm representatives did not adequately explain to customers the costs and features of variable annuities. Finally, the firm failed to establish, maintain and enforce adequate supervisory policies and procedures governing the sale of variable annuities and variable life insurance. The firm agreed to a censure and a $350,000 fine.

InterSecurities, Inc. (Case Number C05030020 (May, 2003)): The firm was sanctioned for failing to establish and maintain adequate written supervisory procedures and systems for reviewing and addressing customer complaints and the sale of variable products. Specifically, the procedures did not adequately provide for identification of correspondence as complaints, and as a result certain complaints went unreported to NASD. The firm failed to obtain certain information related to customer suitability. The suitability of the firm's written supervisory procedures did not provide adequate guidance on the suitability of variable life insurance transactions. Also, the firm did not have a written policy requiring that principals review certain customer information for suitability. The firm agreed to a censure and a fine of $125,000.

Ralph T. Grubb (Case Number C05030019 (May 27, 2003)): Ralph Grubb, at the time employed by Banc of America Investment Services, Inc., was charged with an unsuitable sale of a deferred variable annuity to an 18-year-old high school senior who was seeking a safe investment for a $30,000 legacy while in college. When she graduated from college, she intended to use the funds for a down payment on a house or to buy a car. However, the annuity contract was subject to a ten percent additional tax on distributions prior to age 59 ½ and carried surrender charges that would have still been in effect when she intended to liquidate her investment. The complaint alleged that Grubb's recommended allocation of 100 percent of the customer's premium to one underlying fund within the annuity was unsuitable in relation to the customer's risk tolerance, and that the customer had no need for the death benefit feature of the annuity because she was unmarried and had no dependents. Moreover, the customer was in the lowest marginal tax bracket and had no need for tax-deferral, a principal reason for the purchase of variable annuities. The complaint further alleged that Grubb made an unsuitable sale of a deferred variable annuity to the customer's father for the investment of a legacy received by the customer's 16-year-old sister. Grubb settled the matter by agreeing to a 15 business day suspension and demonstration of an inability to pay a monetary sanction.

Kevin S. Jones (Case Number C05030015 (May 27, 2003)): Kevin S. Jones was charged with an unsuitable switch of variable annuities. At the time, Jones was employed at Raymond James and Associates, Inc. The customer, a self-employed rancher, needed access to her funds and had an investment time horizon of two to seven years. During the sixth year of her ownership of a $300,000 variable annuity, Jones recommended that she switch to another variable annuity in the amount of $315,000, for which Jones received a commission of $8500. The original variable annuity would have allowed the customer penalty-free access to her money in eight months, but the switch resulted in limited access to her investment for the next nine years. The switch also caused the customer to pay a $1600 surrender fee. The switch resulted in no significant improvement in the death benefit for the customer and caused the customer to pay substantial increased annual costs. Over a six-year period, these increased costs depleted the $15,000 bonus offered by the second variable annuity. Jones settled the matter by agreeing to a 10 business day suspension and a fine in the amount of $10,900, which included $8,500 in commissions. He also agreed to pay $1,600 in restitution to the customer.

John Steven Blount (Case Number C05030034 (January 12, 2004)): John Steven Blount of Lake Charles, Louisiana was barred from association with any NASD member and ordered to pay restitution in the total amount of $1,549,561.32 plus interest to 10 customers for unsuitable sales of variable annuities and mutual funds totaling over $6 million. The unsuitable sales generated almost $220,000 in commissions. NASD found that Blount’s conduct involved a scheme to defraud investors and to frustrate attempts by his employer to supervise his activities. The transactions took place between 1998 and 2001, while Blount was a registered representative of NYLife Securities, Inc. Blount's customers were older, conservative investors who were generally seeking current income from their investments. NASD found that Blount's investment recommendations exposed his customers to excessive market risk, lacked sufficient liquidity, and failed to address the customers' needs for current income. In one instance, the customer was a 62 year-old retiree who wished to keep his principal investment safe, and had told Blount that he anticipated the need within a few months for $50,000 to buy a car and to make home repairs. Despite the customer's near-term need for liquidity, Blount recommended that the customer invest almost all of his liquid assets in a variable annuity contract that imposed surrender charges for early withdrawals during the first six years of the contract. Furthermore, Blount recommended allocating the investment to high-risk sub-accounts that were not consistent with the customer's desire to keep his principal safe. In order to buy a car and make home repairs, the customer was forced to draw on his home equity and subsequently had to take early withdrawals from his variable annuity to make the resulting loan payments. NASD also found that Blount misrepresented material features of the variable annuities in order to induce customers to purchase the products. Additionally, in an effort to circumvent his firm's review of annuity and mutual fund transactions, Blount directed his sales assistant to falsify firm records regarding customer's financial situations and investment objectives.

Waddell & Reed, Inc., Robert Hechler, and Robert Williams (Case No. CAF040002 (January 14, 2004)): NASD filed a complaint charging Waddell & Reed, Inc. for recommending 6,700 variable annuity exchanges to its customers without determining the suitability of the transactions. These exchanges, known as "switching," generated $37 million in commissions and cost Waddell's customers nearly $10 million in surrender fees. NASD also alleged that according to its quantitative analysis, at least 1,400 of the firm's customers were likely to lose money by making these switches. Charges were also brought against the firm's former President, Robert Hechler, and its National Sales Manager, Robert Williams. In addition to other sanctions, NASD is seeking an order requiring the firm to disgorge commissions and compensate customers. According to the complaint, between January 2001 and August 2002, Waddell engaged in an aggressive campaign to switch the variable annuity contracts of its customers from those issued by one insurance company, United Investors Life Insurance Co. (UILIC), to very similar annuities provided by another insurance company, Nationwide Insurance Co. The Complaint alleges that in doing so, Waddell & Reed failed to take adequate steps to determine whether there were reasonable grounds for the customers to enter into these exchanges, such as determining whether the customers were likely to benefit or lose money from the exchanges, and failed to establish sufficient guidance for the sales force to use in determining the suitability of the exchanges.

Prudential Equity Group, Inc. (Case No. C05040008 (January 29, 2004)): Prudential Equity Group, Inc. (formerly known as Prudential Securities, Inc.) and Prudential Investment Management Services LLC, were fined $2 million and ordered to pay customers $9.5 million for sales of annuities, including variable annuities, that violated a New York State Insurance Department regulation and NASD rules.

From November 1998 through mid-2002, certain Prudential employees repeatedly circumvented Regulation No. 60 of the New York State Insurance Department, which governs replacement sales of annuity contracts. The regulation requires documentation of two separate interactions with a customer, documentation of specific information about the old annuity contract, and disclosure of comparison information before a replacement sale can be completed. The regulation is intended to protect investors by requiring disclosure of information in order to reduce opportunities for misrepresentation and to allow investors to make comparisons between their current annuity and the proposed replacement annuity.

In an organized effort to circumvent the regulation, Prudential employees compressed the procedures to one contact during which customers were instructed to sign, but leave undated, all required forms. Subsequently, employees would insert dates in the documents in order to create an appearance that the two-step procedure had been followed and that there had been an appropriate interval between the steps during which information had been obtained from the issuer of the annuity proposed for replacement. In some instances when customers had dated documents despite instructions not to do so, Prudential employees would alter documents so that it appeared that Regulation No. 60 and the two-step procedure had been followed.

During the three and one-half year period at issue, Prudential completed 906 annuity replacement sales subject to Regulation No. 60, and a substantial number of these involved violations of the regulation.

Additionally, during the same time period, certain Prudential employees prepared and used incorrect annuity performance illustrations in sales of annuity contracts.

Prudential discovered the violations in mid-2002 when a review of a replacement sale uncovered altered documents. Prudential promptly reported the matter to NASD and other regulators, and in consultation with NASD, initiated a remediation program for all affected customers that will result in payments of more than $9.5 million.

Michael H. Tew (Case Number C05040010 (April 7, 2004)): Michael H. Tew, of Dothan, AL, formerly employed by A.G. Edwards & Sons, Inc., was suspended for six months and fined $28,000 for the sale of three unsuitable variable annuities. The first unsuitable sale was to an elderly couple, both of whom were 76 years old at the time of the purchase. Tew knew that the customers were about to enter an assisted-living facility and had a need for liquidity. He also knew that the customers indicated income as their primary investment objective and wished to preserve the principal of their investment for their heir. Investment in the variable annuity accomplished none of these goals. The variable annuity did not allow the customers full access to their funds for seven years without incurring a surrender charge. The variable annuity purchase did not produce income, because Tew recommended investment in capital appreciation and growth sub accounts. In addition, the investment failed to preserve principal for their heir because the death benefit applied only if the customers died before the tenth contract year. Finally, Tew sold the customers a Retirement Income Guarantee Rider that was only available to contract owners 75 years old or younger. At age 76, the customers were ineligible for this rider. Because the variable annuity accomplished none of the investment goals identified by the customers, the customers could not financially benefit from the purchase, rendering the recommendation unsuitable. Tew also made unsuitable variable annuity recommendations in two other instances. Tew agreed to a fine of $28,000 and six months' suspension from the industry for unsuitable sales of deferred variable annuities.

Debora A. Fruge (Case Number C05040024 (May 4, 2004)): Debora A. Fruge, of Sulpher, LA, formerly employed by Banc One Securities Corporation, was found to have made misrepresentations in connection with variable annuity sales, and to have forged certain documents. Fluge made misrepresentations to a customer regarding the balance of a variable annuity account, forged the customer's name to change of address forms, falsified a confirmation relating to the variable annuity account, and failed to provide truthful information to the NASD. Fruge's course of misconduct began with a misunderstanding between Fruge and the customer regarding the nature of the annuity. The customer believed the annuity to be fixed. However, it was, in fact, a variable annuity. Rather than address the misunderstanding, Fruge misrepresented the balance and attempted to conceal her misrepresentations by creating a false confirmation and redirecting the customer's statements and confirmations for delivery to the branch office. Although the firm had procedures to ensure that change of address forms were not changed to post office boxes or branch office addresses, Fruge avoided detection by changing the address through the variable annuity company, rather than through her firm. Fruge agreed to a bar from the industry.

Daniel Karl Park (Case Number C06040008 (May 14, 2004)): Daniel Karl Park, of Frisco, TX, formerly employed by Northwestern Mutual Investment Services, was barred from association with any NASD member in any capacity for signing the name of his wife to six different variable annuity withdrawal requests and then converting the funds without his wife's authorization. Park agreed to a bar from the industry.

American Express Financial Advisors (Case Number C05040017 (May 20, 2004)): The firm was found to have failed to preserve certain records in a non-rewriteable, non-erasable format as required by SEC rules. The records included copies of account statements, certain confirmations, and letters sent to customers confirming changes of address. These violations came to light as a result of NASD's investigation of the activities of a former registered representative of American Express who made unauthorized sales and cash withdrawals totaling $124,900 from a customer's variable annuity and who then converted the funds. The representative avoided detection for almost two and one-half years because he had changed the customer's address on the records of American Express to the representative's own address. The firm was sanctioned for inadequate record keeping during a four-year period. The firm agreed to a censure and a $300,000 fine.

Nationwide Investment Services Corporation and ***Nationwide Securities, Inc.*** (Case Number C05040021 (May 20, 2004)): These affiliated firms distributed variable products advertising that contained deficiencies, including failures to: prominently disclose the charges and fees associated with the product; explain that dollar cost averaging does not insure profit or protect against loss; clearly identify the product as a variable annuity and/or variable universal life insurance product, and provide a balanced presentation of the risks and benefits associated with investing in a variable annuity.

Nationwide Investment Services Corporation also failed to implement procedures to obtain customer information critical to evaluating the suitability of a variable annuity investment. In many instances, the firm failed to obtain information about tax bracket, prior investment experience, annual income, liquid net worth, risk tolerance, time horizon, investment objective, customer age or the details of the product being replaced by the variable annuity investment. The firm also failed to provide registered representatives with specific guidelines for evaluating information obtained from a customer prior to recommending the purchase of a variable annuity. The firm was sanctioned for having inadequate procedures and systems governing their sale of variable annuities, and both firms were sanctioned for distributing advertising and sales literature that failed to make required disclosures regarding variable annuity investments. The firms agreed to a censure and fines totaling $175,000.