

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS**

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

JEFFREY B. PIERCE

(CRD No. 3190666),

Respondent.

Disciplinary Proceeding

No. 2007010902501

Hearing Officer—Sara Nelson Bloom

HEARING PANEL DECISION

January 30, 2012

Respondent is suspended from associating with any member firm in any capacity for one year and fined \$25,000 for: 1) concealing annuity switches in customer accounts, in violation of NASD Conduct Rule 2110; 2) providing false documentation to his firm regarding annuity transactions, in violation of NASD Conduct Rules 3110 and 2110; 3) willfully failing to disclose material facts to customers, in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and NASD Conduct Rules 2120 and 2110 and IM-2310-2; and 4) intentionally making material misrepresentations to his firm, in violation of NASD Conduct Rule 2110.

Appearances

Michael J. Newman, Esq. and Stuart P. Feldman, Esq., for the Department of Enforcement.

Michael B. Cosentino, Esq. and Susan D. Novins, Esq., for the Respondent.

DECISION

I. Introduction

On May 28, 2010, the Department of Enforcement filed a five-cause complaint against Jeffrey B. Pierce (“Respondent”) alleging various violations relating to annuity switches in customer accounts.¹ The first cause alleges that Respondent circumvented his firm’s procedures

¹ Following consolidation of NASD and the member regulation, enforcement, and arbitration functions of NYSE Regulation into FINRA, FINRA began developing a new “Consolidated Rulebook” of FINRA Rules. The first phase of the consolidated rules became effective on December 15, 2008. See FINRA Regulatory Notice 08-57, 2008 FINRA LEXIS 74 (Dec. 8, 2008). Because the Complaint in this case was filed after December 15, 2008, the procedural rules that apply are the FINRA rules of procedure. The conduct rules that apply are those that existed at the time of the conduct at issue.

to conceal annuity switches involving seven customers, in violation of NASD Conduct Rule 2110. The second cause alleges that Respondent provided false documentation to his firm regarding the annuity switches, in violation of NASD Conduct Rules 3110 and 2110. The third cause alleges that Respondent fraudulently and willfully failed to inform four customers of material facts pertaining to surrender charges, tax liabilities, and the availability of “1035 exchanges”² to defer taxes, in violation of Section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”) and Rule 10b-5 thereunder, NASD Conduct Rules 2120 and 2110, and IM-2310-2. The fourth cause alleges that annuity switches in seven customer accounts were unsuitable, in violation of NASD Conduct Rules 2310 and 2110 and IM-2310-2. The fifth cause alleges that Respondent intentionally made material misrepresentations to his firm regarding whether the customers incurred any adverse tax consequences as a result of the annuity surrenders, in violation of NASD Conduct Rule 2110.

Respondent filed an Answer to the Complaint on July 1, 2010, denying the charges and requesting a hearing. A six-day hearing was held on January 12-14, February 16-17, and February 25, 2011, before a Hearing Panel composed of the Hearing Officer, a former member of the District 11 Committee, and a current member of the District 8 Committee. Nine witnesses testified, including Respondent.³ Enforcement filed a post-hearing brief on April 15, 2011.

Respondent filed a post-hearing brief on May 13, 2011.

² A “1035 exchange” refers to a tax-exempt exchange of one annuity contract for another under Section 1035 of the Internal Revenue Code. See 26 U.S.C. § 1035.

³ “TR.” refers to the transcript of the hearing. Enforcement’s exhibits are labeled “CX.” Respondent’s exhibits are labeled “RX.” CX-1, CX-2A, CX-2B, CX-3A, CX-3B, CX-4A, CX-4B, CX-4D, CX-4E, CX-5A, CX-5B; CX-6A, CX-6B, CX-7A, CX-7B, CX8A, CX-9, CX-10, CX-12 -15, RX-1 – RX-12, RX-14 – RX-19, and RX-21 were admitted into evidence.

II. Origin of Investigation

The investigation leading to this proceeding followed a customer complaint against Respondent.⁴

III. The Respondent

From October 2000 through May 2008, Respondent was registered as an Investment Company and Variable Products Representative through FINRA member firm IFMG Securities (“the Firm”).⁵ On May 15, 2008, the Firm filed a Form U5 indicating that Respondent “was permitted to resign after review of certain annuity transactions found that he failed to follow Firm policy with respect to the processing of annuity contracts.”⁶ After leaving the Firm, Respondent became registered with other member firms, and he was registered when the Complaint in this matter was filed.⁷

IV. Facts

The conduct at issue focuses on annuity switches. Enforcement alleges that Respondent concealed annuity switches from his firm, falsified documents regarding the switches, fraudulently omitted information regarding the switches from four customers, engaged in unsuitable switches for seven customers, and made misrepresentations to the Firm when it inquired about Respondent’s annuity switching activities.

A. Annuities Overview

Annuities are contracts where, in return for an investment of a lump sum of money, an insurance company promises to make periodic payments to an investor, starting immediately or

⁴ Tr. I, p. 166.

⁵ *Id.* The Firm was acquired by another FINRA member firm in 2008. Tr. I, p. 169.

⁶ CX-9, p. 54.

⁷ CX-9, pp. 2, 57-59.

at some future time.⁸ Annuities can have fixed or variable rates of return. The rate of return for variable annuities is not stable, but varies with the stock, bond, and money market sub-accounts that are selected as investment options.⁹

Annuities are intended to be long-term investments. There is generally a surrender charge for withdrawals before a specified period, typically from five to eight years. This charge generally decreases over time.¹⁰ Earnings are tax deferred until they are withdrawn. Earnings (but not principal) withdrawn from a variable annuity are taxed at the ordinary income rate. Investors may generally exchange an existing variable annuity contract for a new annuity contract without triggering a tax liability by using a 1035 exchange. If an annuity is liquidated without a 1035 exchange, immediate tax liabilities may be triggered.¹¹

B. Respondent Facilitates Annuity Switches in Customer Accounts

During the relevant period, Sovereign Bank (“the Bank” or “Sovereign”) contracted with the Firm to provide brokerage services to bank customers.¹² Respondent was among the Firm’s registered representatives designated to provide these services. He covered approximately ten Bank branches in the greater Boston area over the course of his career at the Firm.¹³ Respondent generally did not independently solicit business. Instead, he relied upon Bank employees to identify Bank customers with cash positions, certificates of deposit that were maturing, or annuities with expiring surrender periods. These Bank employees scheduled meetings between

⁸ See, FINRA Investor Alert (Mar. 2, 2006), available at <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/AnnuitiesAndInsurance/P006045>.

⁹ For fixed annuities the earnings and payout are guaranteed by the insurance company. *Id.* For variable annuities, income riders may be available for purchase to obtain a set interest payment. However, the underlying principal may still be subject to market risk. *Id.*

¹⁰ Other annuity fees include mortality and expense risk charges, which the insurance company charges for the insurance risk it takes under the contract; administrative fees, for recordkeeping and other administrative expenses; underlying fund expenses, relating to the stock or bond investment options selected. There are additional charges for special features, such as a stepped-up death benefit, a guaranteed minimum income benefit, or protection of principal. *Id.*

¹¹ *Id.*

¹² TR. II, pp. 21 -23.

¹³ *Id.*, TR.II, pp. 6, 178.

the customers and Respondent for the purpose of selling annuities to the customers.¹⁴ During his tenure at the Firm, Respondent became one of the Firm's largest producers, with gross commissions of \$600,000 - \$950,000 in 2007.¹⁵ Because most of his customers had modest financial resources, Respondent had to do a large volume of business to generate this level of compensation.

The annuity switches in this case involved seven customers, AP, PB, ML, LC, CC, VG, and CY. The customers ranged in age from 66 to 74.¹⁶ Most were retired. Some owned homes that had appreciated in value, and others lived in rental apartments. All had modest financial resources and investment experience limited to the purchase of one or two annuities through the Bank's relationship with the Firm. As a result of the annuity switches that Respondent recommended, four of the customers incurred surrender charges, and six were required to pay taxes on gains associated with the surrenders.¹⁷ The details of the customer transactions are discussed below.

a. AP

When AP met with Respondent, she was a 70 year-old retiree who lived in a rented apartment. She was an inexperienced investor who had net assets of less than \$60,000, including an annuity, and a monthly income of \$2,400 from social security and a small pension. In completing AP's account documentation, Respondent overstated her assets and investment experience, indicating that she had an annual income of \$50,000, a liquid net worth of \$300,000, and a total net worth of \$600,000. Respondent also falsely indicated that AP had five to ten

¹⁴ TR.III, pp. 6-7,109; TR. V, p.78; Respondent was not the broker of record on any of the clients at issue prior to meeting with them. As a result, he did not have access to their financial information on record at the Firm. TR.V, pp. 79-80.

¹⁵ TR.V, p. 179.

¹⁶ CX-1.

¹⁷ *Id.*

years of experience investing in stocks and bonds, and 25 years of overall investment experience, when in fact her experience was limited to the purchase of an annuity through the Firm in 2004.¹⁸

AP trusted Respondent and relied upon his advice. She therefore followed Respondent's recommendation in January 2007 to surrender her annuity and switch to a new annuity.¹⁹ She used the \$28,367.15 in proceeds from the sale of her annuity, along with her remaining savings and \$18,000 of her mother's savings, to purchase the replacement annuity for \$55,032.33.²⁰ She signed the documents that Respondent prepared without reading them.²¹

Respondent arranged for the proceeds of the annuity sale to be paid by check mailed to the Bank rather than direct deposit to AP's account, making it more difficult for the Firm to detect that the transaction was an annuity switch.²² Respondent was required to complete an Annuity Reporting Sheet for every annuity purchase.²³ He indicated on AP's Annuity Reporting Sheet that the new annuity was being purchased by check, rather than the liquidation of another annuity.²⁴

AP's new variable annuity was subject to a surrender charge that would be assessed if she liquidated all or part of the annuity prior to a seven-year period.²⁵ In addition, because the holding period for her previous annuity had not expired, AP incurred a \$1,798.45 surrender charge.²⁶

¹⁸ CX-3 pp. 23-24; CX-10, pp.146-147; TR. I pp. 66-69.

¹⁹ CX-10, pp. 139-140; CX-10, pp. 122-135; CX-3, pp. 37-38. TR. I, pp. 66, 83; TR. V, p. 151.

²⁰ CX-1; CX-10, pp. 139, 150-158. The new annuity carried an optional rider providing a \$240 monthly payment. There is no evidence as to the cost of this rider.

²¹ *Id.*

²² CX-3, pp. 37-38; CX-10, pp. 136-137.

²³ TR. II, pp. 184-185.

²⁴ CX-10, p. 122.

²⁵ CX-10, p. 127.

²⁶ CX-1.

As part of his responsibility to act in his customer's best interests, Respondent should have used a 1035 exchange to defer taxes.²⁷ Because a 1035 exchange was not used, AP incurred a taxable gain of \$4,367.15, resulting in an income tax liability of \$1,310.15.²⁸

b. PB

When PB met with Respondent, she was a 74 year-old widowed homemaker who was born in Holland. She had an annual income of approximately \$20,000 - \$25,000, consisting of social security payments and rental income that she used to pay her mortgage.²⁹ Other than her home, PB's only material asset was a \$100,000 Sun Life fixed annuity that she had purchased through the Firm in 2002 with proceeds from the sale of a family business.³⁰ Nonetheless, Respondent indicated on PB's account documentation that he submitted to the Firm that PB had annual income of \$50,000 and a liquid net worth of \$300,000. He also indicated that she had five to ten years experience investing in stocks, bonds, and mutual funds, and 25 years overall investment experience, when in fact PB's only experience was purchasing the annuity through the Firm in 2002.³¹

Over the years since 2002, PB made withdrawals from her \$100,000 annuity, causing the value of the annuity to decline. At the time she met with Respondent, PB's annuity was worth approximately \$57,000.³²

PB trusted Respondent and relied upon his advice. She therefore followed Respondent's recommendation, in February 2007, to surrender her fixed annuity for \$57,143.90 and invest in

²⁷ CX-10, p. 16.

²⁸ CX-1; CX-10, pp. 15-16.

²⁹ TR. I pp. 33-36, 41.

³⁰ TR. I pp. 38, 58; The fixed annuity had no monthly payout. TR. I pp. 36-38, 52-53, 54-55; RX-4 p. 5.

³¹ CX-10, p. 317; TR. I pp. 34, 37, 40.

³² Her testimony regarding her financial resources was generally consistent with the customer documentation completed by another representative in 2002 which reflected net worth of \$250,000 and annual income of \$20,000. CX-6, p. 3.

an ING variable annuity for \$50,000.³³ There was no surrender charge associated with the switch.³⁴

Respondent had PB sign various forms, but she did not read them because she trusted Respondent.³⁵ As he had done with AP's account, Respondent structured the annuity sale so that the proceeds would be paid by check rather than direct deposit to PB's account.³⁶ Respondent then indicated on the Annuity Reporting Sheet that PB's purchase of the new annuity was funded by a check rather than the liquidation of an annuity.³⁷

Again, Respondent could have deferred PB's taxes on the surrender by using a 1035 exchange if the transaction had been accurately characterized as a switch.³⁸ However, Respondent did not do so. Because he did not use a 1035 exchange, PB's gain of \$7,143 was taxable, resulting in an income tax liability of \$1,432.³⁹ PB's new variable annuity was subject to a surrender charge that would be assessed if she liquidated all or part of the annuity prior to an eight-year period.⁴⁰

c. ML

When ML met with Respondent, she was a 74 year-old widow who lived in a condominium that she owned.⁴¹ ML was an inexperienced investor who had limited financial resources.⁴² She had to supplement her social security income by working part-time at Costco.⁴³

³³ CX-1; The ING variable annuity had a rider that paid a lifetime monthly cash benefit.³³ There is no evidence as to the cost of this rider.

³⁴ CX-1.

³⁵ TR I, pp. 40-42, 44-59.

³⁶ CX-10, pp. 322-323.

³⁷ CX-10, p. 316.

³⁸ CX 12, pp. 11-12.

³⁹ CX-1; CX-10, pp. 15-16.

⁴⁰ CX-10, pp. 312, 321. PB is still unaware that she owns a variable annuity, believing instead that she still owns a Sun Life fixed annuity. TR I, pp. 40-42. PB testified: "I still don't know what I have." TR. I, p. 56.

⁴¹ Tr. I, p. 123.

⁴² TR. V, p. 56.

⁴³ Tr. V p. 59; CX-11, p. 105.

Her annual income was \$24,000.⁴⁴ Respondent overstated ML's financial resources and investment experience on her account documentation, indicating that she had an annual income of \$60,000, and a liquid net worth of \$150,000. He also indicated that ML had five to ten years of experience investing in stocks and bonds and 30 years overall investment experience, when in fact ML's experience was limited to purchasing an annuity through the Firm.⁴⁵

ML followed Respondent's recommendation, in August 2007, to switch her existing Sun Life fixed annuity worth approximately \$21,984 to an ING variable annuity in the same amount.⁴⁶ ML signed the documents Respondent prepared without carefully reading them because she trusted him.⁴⁷ Respondent documented the sale of the annuity so that the proceeds would be paid by check.⁴⁸ Respondent then indicated on the Annuity Reporting Sheet that the purchase of the new annuity was funded by a "death claim" rather than the liquidation of an annuity.⁴⁹

ML incurred a \$667.28 surrender charge in connection with the liquidation of her existing annuity.⁵⁰ The new variable annuity imposed a surrender charge that would be assessed if she liquidated the annuity prior to a seven-year period.⁵¹ Again, Respondent could have avoided tax liability for ML by using a 1035 exchange.⁵² However, Respondent did not do so. Accordingly, ML's gain of \$2,407.77 was taxable, resulting in an income tax liability of \$674.18.⁵³

⁴⁴ TR I, pp. 109-110.

⁴⁵ CX-10, p. 211.

⁴⁶ TR I, pp. 106-107.

⁴⁷ TR I, p. 113.

⁴⁸ CX-10, p. 215; CX-2, p. 39.

⁴⁹ CX-10, p. 210.

⁵⁰ CX-1.

⁵¹ CX-10, p. 216.

⁵² CX-10, p. 16.

⁵³ CX-1; CX-10, pp. 15-16.

d. LC

When LC met with Respondent, she was a 72 year-old divorcee and a lifelong homemaker who could not speak English.⁵⁴ LC relied on her son, FC, to interpret and assist her in all financial matters.⁵⁵ LC's income was approximately \$700 per month, consisting of a social security payment of \$380 to \$420 and approximately \$300 from her \$60,000 fixed annuity held at the Firm.⁵⁶ LC's liquid assets were limited to her fixed annuity.⁵⁷ Respondent overstated LC's financial resources and investment experience on her account documentation, indicating that she had annual income of \$30,000 and a liquid net worth of \$300,000. Again, he indicated that LC had five to ten years of experience investing in stocks and bonds, and 25 years of overall investment experience, when in fact her experience was limited to purchasing an annuity through the Firm.⁵⁸

LC and FC were inexperienced investors who trusted Respondent and relied on his advice. Accordingly, in July 2007, LC signed paperwork to surrender her \$60,000 Sun Life fixed annuity and apply \$50,000 of the proceeds to purchase an ING variable annuity.⁵⁹ Respondent arranged for the proceeds of the annuity liquidation to be paid by check.⁶⁰ Again, Respondent failed to use a 1035 exchange to defer taxes. As a result, LC incurred a tax liability of \$429.18.⁶¹

e. CC, VG, and CY

CC, VG, and CY did not testify at the hearing. Evidence offered at the hearing established that CC surrendered her existing \$78,875.30 annuity in November 2006 and

⁵⁴ TR II, pp. 119, 124.

⁵⁵ TR V, p. 156. FC testified at the hearing on LC's behalf. TR II, pp. 120-121, 125.

⁵⁶ TR II, pp. 121, 129.

⁵⁷ TR II, p. 129.

⁵⁸ CX-10, p. 293.

⁵⁹ CX-10, p. 297; TR. II, p. 129.

⁶⁰ CX-10, pp. 298-299.

⁶¹ CX-1.

purchased a replacement annuity in the amount of \$94,262.89 seven days later, incurring a surrender charge of \$3,532.03 and a taxable gain of \$20,008.13.⁶² Similarly, VG surrendered her existing \$36,802.90 variable annuity in February 2007 and purchased a replacement annuity in the amount of \$33,802.90 eight days later, incurring a surrender charge of \$2,349.12.⁶³ There was no taxable gain on the transaction. Finally, CY surrendered his existing \$12,284.22 fixed annuity in March 2007 and purchased a replacement annuity in the amount of \$10,000, incurring a surrender charge of \$2,290.97.⁶⁴ There was no taxable gain on the transaction.

C. Respondent Concealed the Annuity Switches from his Firm

Respondent took a number of actions to conceal the annuity switches from his Firm. First, he directed that the proceeds of the liquidation of the annuities be paid by check mailed to the Firm, rather than depositing the proceeds directly into the customers' accounts, making it less likely that the Firm would make a connection between the liquidations and the purchases of the new annuities.

Second, he provided false information on the Firm's Annuity Reporting Sheets as to the funding source for the new annuity purchases in all seven customer accounts.⁶⁵ Specifically, Respondent falsely indicated that the funding source for the annuity was a checking account for the AP, PB, and CY accounts; a property sale for the CC account; a certificate of deposit for the VG account; insurance proceeds from an inheritance for the LC account; and a "death claim" for the ML account.⁶⁶

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ TR. II, pp. 183-191; CX-10, p. 77.

⁶⁶ CX-10, pp. 77, 122, 128-134, 192, 210, 292, 316, 338. Respondent exacerbated this misrepresentation when he later told his Firm that LC's husband had recently passed away. CX-10, p. 287. In fact, LC's husband is still alive and had been divorced from LC for eight years. TR II, p. 143.

Third, Respondent failed to complete a Firm Replacement Switch Disclosure Form (“Switch Form”) which is required when an annuity is to be replaced with another annuity.⁶⁷ By doing so, Respondent deprived customers of important information regarding surrender charges, costs, and tax implications and deprived his Firm supervisors of the ability to exercise heightened scrutiny over the transactions.⁶⁸

Finally, as discussed in greater detail below, Respondent failed to disclose to the customers that they could have used a 1035 exchange to defer taxes in connection with their annuity switches.

D. Respondent’s Disclosures to Customers

Enforcement charges that Respondent failed to inform four customers of material facts in three areas: (i) surrender charges; (ii) tax liabilities; and (iii) the availability of 1035 exchanges.

The Hearing Panel finds that Enforcement failed to establish by a preponderance of the evidence that Respondent failed to disclose surrender charges and tax liabilities.⁶⁹ Respondent testified that he disclosed the surrender charges and tax liabilities to the customers. Although the customers generally did not recall this disclosure, each of them initialed forms acknowledging that they understood that they might incur tax liabilities, and none of them complained about tax liabilities at the time.⁷⁰ In fact, one customer testified that she knew she would need to pay taxes on the transaction.⁷¹ The Hearing Panel also considered the fact that the customers’ pattern of

⁶⁷ Respondent claimed that he completed the required Switch Forms in all but one customer account. Respondent testified that he placed the forms in his original files in the branch. TR. V, p. 184. However, the Firm did not have these forms among its records. Respondent offered no explanation for why he would not have submitted the forms for supervisory review, as required. Moreover, none of the customers had copies of these forms. In addition, failing to complete the Switch Forms was consistent with Respondent’s pattern of behavior, including his false answers to ING, the annuity issuer for six of the replacement transactions, that the transactions were not replacements. CX-6, p. 3; CX-10, pp. 82-89. Therefore, the Hearing Panel did not find Respondent’s claim to be credible.

⁶⁸ TR. II, pp. 173-174, 191; CX-13, pp. 150, 173.

⁶⁹ TR I, pp. 40-42, 67, 91, 112-113; TR II, pp. 129-130.

⁷⁰ TR I, pp. 40-42, 67, 91, 112-113, 151-152; TR II, pp. 129-130; *See, e.g.* CX-10, p. 127.

⁷¹ TR I, p 55.

interaction with Respondent was not to question Respondent's recommendations or listen carefully to what he told them. Instead, they simply trusted him and followed his advice. Moreover, Respondent's disclosure of tax liabilities was consistent with his concealment of the switches, because the customers who were paying attention would then not be surprised when taxes were assessed.

On the other hand, the Hearing Panel found that the preponderance of the evidence established that Respondent did not disclose to customers AP, PB, LC and ML that they could use 1035 exchanges to defer taxes. In reaching this finding the Hearing Panel considered that the customers consistently and reasonably testified that if they had been offered the option to defer taxes, they would have done so. Moreover, a disclosure that 1035 exchanges were available on the annuity switches would have revealed to the Firm that the transactions were annuity switches.⁷² The Hearing Panel finds that these factors also establish that Respondent's failure to disclose the availability of 1035 exchanges was willful.

E. Respondent Provided False Information to the Firm in its Internal Review

The Firm began an internal review of Respondent's annuity business in October 2007 after Sun Life reported that Respondent misrepresented on an Annuity Reporting Sheet that the source of funds to purchase an annuity was a CD rather than the liquidation of another annuity.⁷³ As part of the review, the Firm requested that Respondent complete a comprehensive questionnaire for each replacement trade.⁷⁴ Respondent provided false information in these questionnaire responses regarding the issue of whether the customers had incurred any "adverse

⁷² For example, Firm procedures required pre-approval of 1035 exchanges involving surrender charges. TR. III, pp. 160-161. TR V, pp. 151-152.

⁷³ CX 10, pp. 53-54; TR.II, pp. 207-210.

⁷⁴ TR.III, pp. 258-259.

tax consequences” through their annuity sales.⁷⁵ Respondent answered “No” to this question despite the fact that the customers incurred tax liability through the liquidation of their annuities.⁷⁶ At the Hearing, Respondent admitted that his answers were false, but explained that this was attributable to the fact that he was on paternity leave and did not have access to his files when he answered the questions, and he did not think it was a serious inquiry.⁷⁷ Given Respondent’s pattern of false disclosures and his motive to hide his misconduct, the Hearing Panel did not find his explanation credible. Instead, the Hearing Panel found that Respondent’s misrepresentations to the Firm were intentional.

V. Conclusions of Law

A. Respondent Violated Conduct Rule 2110 by Concealing Annuity Switches

Respondent is charged with circumventing the Firm’s procedures to conceal annuity switches in customer accounts. A respondent violates NASD Conduct Rule 2110 when he engages in unethical conduct.⁷⁸ FINRA’s National Adjudicatory Council recently reaffirmed that failure to properly document variable annuity transactions constitutes unethical conduct under Conduct Rule 2110 because it circumvents supervisory review.⁷⁹

The Hearing Panel finds that between November 2006 and July 2007, Respondent circumvented Firm procedures in connection with seven annuity replacement transactions. Respondent directed that the proceeds of the surrendered annuity be paid by check rather than direct deposit to the customer’s account, making it appear that the transaction was not an annuity switch. He also presented the variable annuity purchase as a new investment rather than a

⁷⁵ CX-1; CX-10, pp. 422-456.

⁷⁶ See, e.g. CX-10, p. 140.

⁷⁷ TR.IV, pp. 120-122.

⁷⁸ *Id.* See *Department of Enforcement v. Davenport*, No. CO5010017, 2003 NASD Discip. LEXIS 4, at *8 (NAC May 7, 2003).

⁷⁹ *Department of Enforcement v. Skiba*, No. E8A2004072203, 2010 FINRA Discip. LEXIS 6 at *13-14 (NAC April 23, 2010) (finding a violation for submitting inaccurate variable annuity applications and failing to submit variable annuity replacement forms).

replacement. Specifically, Respondent did not identify the sale of an annuity as the source of funds for the new annuity on the Annuity Reporting Sheets. Instead, he falsely indicated that the source was a checking account, property sale, a certificate of deposit, an inheritance, or a death claim. In addition, he failed to complete a Switch Form for each of the replacement transactions, thereby avoiding the Firm's scrutiny. Respondent also concealed the switches when he failed to use 1035 exchanges to defer tax liability in six of the seven switches at issue.

By concealing annuity switches from his Firm, Respondent violated NASD Conduct Rule 2110.

B. Respondent Violated Conduct Rules 2110 and 3110 by Providing False Information on Annuity Documents

Respondent's falsification of annuity documents also violated NASD Conduct Rules 3110 and 2110. FINRA Rule 3110 requires member firms to "make and preserve records in conformity with all applicable rules and regulations." Entering false information into a member firm's records for the purchase or sale of a security, such as a variable annuity contract, violates Rule 3110.⁸⁰ Here, Respondent entered false information on Annuity Reporting Sheets as to the source of funds for the purchase of the variable annuities at issue, when the true source was the surrender of a pre-existing annuity. An associated person acts in contravention of just and equitable principles of trade by falsifying records.⁸¹

By providing false information on annuity documents, Respondent violated NASD Conduct Rules 3110 and 2110.

⁸⁰ See *Department of Enforcement v. Correro*, No. E102004083702, 2008 FINRA Discip. LEXIS 29, at *14-15 (NAC Aug. 12, 2008); *Department of Enforcement v. Prout*, No. C01990014, 2000 NASD Discip. LEXIS 18, at *8 (NAC, Dec. 18, 2000); *Department of Enforcement v. Skiba* at *6.

⁸¹ *Department of Enforcement v. Mizenko*, No. C8B030012, 2004 NASD Discip. LEXIS 20, at *17-18 (NAC Dec. 21, 2004), *aff'd* Exchange Act Rel. No. 52600, 2005 SEC LEXIS 2655 (Oct. 13, 2005); *Department of Enforcement v. Brack*, No. C9B020048, 2003 NASD Discip. LEXIS 8 at *16-17 (OHO Feb. 7, 2003).

C. Respondent Made Fraudulent Omissions to Customers

The Complaint charges Respondent with willfully failing to inform four customers (AP, PB, ML and LC) of material facts pertaining to surrender charges, tax liabilities, and the availability of 1035 exchanges, in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, NASD Conduct Rules 2120 and 2110, and IM-2310-2.

NASD Conduct Rule 2120, an antifraud rule, parallels Exchange Act Rule 10b-5, and provides that no member shall effect any transaction, or induce the purchase or sale of any security, by means of any manipulative, deceptive or fraudulent device.⁸² Both Rules 2120 and 10b-5 are designed to ensure that sales representatives fulfill their obligations to their customers to be accurate when making statements about securities.⁸³

To establish a violation of Section 10(b) of the Exchange Act and Rule 10b-5, the Hearing Panel must find that Respondent made material misrepresentations or omissions in connection with the purchase or sale of a security, acted with scienter, and used the instrumentalities of interstate commerce, the mails, or any facility of a national securities exchange.⁸⁴

Here, the Hearing Panel found that Respondent willfully omitted to inform customers that they could avoid tax consequences through 1035 exchanges.

The omitted information must be material. Materiality of a fact under Rule 10b-5 depends on “the significance the reasonable investor would place on the withheld or misrepresented information,” and Enforcement must show that such information “would have

⁸² NASD IM-2310-2 states that fraudulent activities violate a registered representative’s responsibility of fair dealing with customers.

⁸³ *District Bus. Conduct Comm. v. Euripides*, 1997 NASD Discip. LEXIS 45 (NBCC July 28, 1997). A violation of NASD Conduct Rule 2120 is also a violation of NASD Conduct Rule 2110. *Department of Enforcement v. Cipriano*, No. C07050029, 2007 NASD Discip. LEXIS 36, at *23 (NAC July 26, 2007).

⁸⁴ *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450 (2d Cir. 1996). The interstate commerce requirement is satisfied in this case by the mailing of documents evidencing the sale of annuities to customers.

been viewed by the reasonable investor to have changed the total mix of information made available.”⁸⁵ Information regarding the availability of a 1035 exchange was material information, as it would have allowed customers to defer paying taxes. FINRA has repeatedly emphasized the importance of communicating important facts to variable annuity customers, such as tax issues.⁸⁶

Scienter is “a mental state embracing intent to deceive, manipulate or defraud.” Recklessness or knowledge will satisfy the scienter requirement. Here, Respondent acted with scienter. Respondent was required to offer the customers the opportunity to use 1035 exchanges to defer taxes on replacement transactions. However, he did not do so in order to conceal the switches.

By failing to disclose the availability of a 1035 exchange to defer taxes, Respondent willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and violated NASD Conduct Rules 2120 and 2110, and IM-2310-2.

D. Respondent Made Misrepresentations to the Firm during its Internal Review

The Complaint charges Respondent with making misrepresentations to his Firm regarding whether his customers were subject to adverse tax consequences as a result of their annuity purchases.

NASD Conduct Rule 2110 states that “[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.” Rule 2110 is a broad ethical principle designed to protect the overall integrity of the securities

⁸⁵ *SEC v. Hasho*, 784 F. Supp. 1059, 1108 (S.D.N.Y. 1992).

⁸⁶ *See, e.g.* NTM 00-44, NTM 99-35.

industry.⁸⁷ NASD Conduct Rule 2110 prohibits misrepresentations and omissions of material fact.⁸⁸

As part of an internal review, the Firm asked Respondent to complete a questionnaire that asked whether the customers had incurred adverse tax consequences through their annuity liquidations. Respondent falsely answered “No” to this question for all seven customers at issue in this case, despite the fact that six customers incurred taxable gains. Respondent asserts that he was on paternity leave, did not have access to his records, and did not take the inquiry seriously.⁸⁹ This was not credible for the same reasons that the Hearing Panel found that Respondent concealed the switches. Moreover, Respondent’s explanation is not a defense to the charge that he provided false information to his Firm.

By making misrepresentations to his member firm, Respondent violated NASD Conduct Rule 2110.

E. The Suitability Charge

The Complaint charges that Respondent recommended unsuitable replacement transactions. The Panel considered that the essence of the Complaint was that Respondent engaged in activity to conceal annuity switching from his Firm, and thus the suitability charge arises from a common course of conduct adequately covered by the other charges. Accordingly, the Hearing Panel determined that it was unnecessary to reach the issue of whether Respondent made unsuitable recommendations, in violation of NASD Conduct Rules 2310 and 2110, and IM-2310-2.

⁸⁷ See *Timothy L. Burkes*, 51 S.E.C. 356, 359, 1993 SEC LEXIS 949, at *8-10 (April 14, 1993); *Benjamin Werner*, 44 S.E.C. 622, 624-25, 1971 SEC LEXIS 163, at *5-6 (July 9, 1971).

⁸⁸ See, e.g., *Gregory A. Eastman*, C3A030012, 2004 NASD Discip. LEXIS 6, at *7 (OHO Feb. 18, 2004).

⁸⁹ TR. IV, pp. 120-122.

VI. Sanctions

The Hearing Panel determined to impose a unitary sanction, given that the charges arose from a common course of action.⁹⁰ The Hearing Panel found two FINRA Sanction Guidelines (“Guidelines”) helpful. In particular, the Guidelines for falsification of documents recommend a fine of \$5,000 to \$100,000 and consideration of a suspension of up to two years where mitigation exists.⁹¹ The Guidelines for intentional misrepresentations or material omissions of fact recommend a fine of \$10,000 to \$100,000 and consideration of a suspension from 10 business days to two years, or, in egregious cases, a bar.⁹²

In determining the appropriate sanction, the Panel considered a number of factors that it found to be aggravating. First, Respondent’s misconduct occurred over almost a year and involved seven customers, all of whom were elderly and of limited financial means and investment experience. In addition, Respondent’s misconduct was motivated by a desire to evade the Firm’s detection of annuity switching. Moreover, Respondent also took numerous steps to conceal annuity switching from his Firm, which indicated to the Panel that Respondent was aware that the switching might be questioned and not approved. Respondent also did not take responsibility for his misconduct; he instead provided false information in connection with the Firm’s inquiry.

Respondent’s explanations for his misconduct were not mitigating. Respondent claimed that he was not properly trained and was overworked. However, the Panel considered that Respondent demonstrated an understanding of the Firm’s procedures based upon his correct documentation of 21 of the 36 switches that were the subject of the Firm’s internal review. Moreover, lack of training or overwork is not a defense, particularly when Respondent’s

⁹⁰ *FINRA Sanction Guidelines* at 4 (2011), available at www.finra.org/sanctionguidelines.

⁹¹ *Id.* at 37.

⁹² *Id.* at 88.

misconduct was intentional. Respondent also pointed out that the customers were reimbursed from his last commission check. However, these payments were based upon the Firm's decision to withhold Respondent's commission rather than at Respondent's initiative. Respondent also argued that, after taxes, he received only \$2,500 in compensation for the annuity switches at issue, which was a minor part of his gross commissions of \$600,000 to \$950,000 at the time. The Hearing Panel did not find the small transaction size to be mitigating, particularly since the transactions involved a significant amount of each customer's liquid net worth.

After careful consideration, a majority of the Panel concluded that a suspension of one year and a fine of \$25,000, payable upon his return to the industry, was warranted.⁹³ In addition, Respondent is statutorily disqualified for willfully violating the Exchange Act and Rule 10b-5 thereunder.⁹⁴

VII. Order

Respondent is suspended from associating with any member firm in any capacity for one year and fined \$25,000 for: 1) concealing annuity switches in customer accounts, in violation of NASD Conduct Rule 2110; 2) providing false documentation to his firm regarding annuity transactions, in violation of NASD Conduct Rules 3110 and 2110; 3) willfully failing to disclose material facts to customers, in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, NASD Conduct Rules 2120 and 2110, and IM-2310-2; and 4) intentionally making material misrepresentations to his Firm, in violation of NASD Conduct Rule 2110. Respondent is

⁹³ One Panelist dissented because he believed that the sanction was too high. He viewed several factors as mitigating. Specifically, he noted the Firm's lack of supervisory controls and failure to establish a culture of compliance. Had the Firm maintained the requisite culture of compliance as required by FINRA and the SEC, the Firm could have deterred inappropriate behavior and/or provided the proper environment for Respondent to engage in the securities business. There is no excuse for Respondent's conduct, but the Firm bears some of the blame, which should be considered a mitigating factor. Further, the Firm withheld compensation from Respondent in connection with the investigation of the customers' transactions. Thus Respondent has already experienced a financial penalty as a result of this misconduct. Accordingly, the dissenting Panelist would not impose a fine, but would impose a suspension of approximately three months.

⁹⁴ The Hearing Panel considered and rejected without discussion all other arguments of the parties.

also ordered to pay the costs of the hearing in the amount of \$10,696.35, which includes a \$750 administrative fee and the cost of the hearing transcripts. If this decision becomes FINRA's final disciplinary action in this proceeding, Respondent's suspension shall begin with the opening of business on March 19, 2012, and end at the close of business on March 18, 2013, and the fine and costs shall be due and payable if and when Respondent applies to associate with a member firm following the end of his suspension.

Sara Nelson Bloom
For the Hearing Panel

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