FINANCIAL INDUSTRY REGULATORY AUTHORITY

OFFICE OF HEARING OFFICERS

Department of Enforcement, Complainant, v. SWS Financial Services, Inc. (CRD No. 17587), Respondent.	DISCIPLINARY PROCEEDING NO. 2011025622001

COMPLAINT

The Department of Enforcement alleges:

SUMMARY

1. During the period from September 2009 to May 2011 ("review period"), SWS Financial Services, Inc. ("SWS" or "Respondent") had inadequate supervisory systems and written supervisory procedures ("WSPs") to supervise its variable annuity ("VA") securities business. As such, the firm violated NASD Rule 3010, FINRA Rule 2010 and numerous provisions of NASD Rule 2821 and FINRA Rule 2330.[1] Specifically, SWS: (1) failed to establish and maintain specific supervisory systems and WSPs to supervise its VA securities business and to ensure compliance with applicable rules and regulations, in violation of NASD Rule 2821(d) and FINRA Rule 2330(d); (2) failed to implement the provisions of NASD Rule 2821(c) and FINRA Rule 2330(c) that mandate: (a) registered principal review and approval prior to transmission of a VA application to the issuing insurance company for processing, and

[1] NASD Rule 2821 (effective May 5, 2008 to February 7, 2010) and FINRA Rule 2330 (effective February 8, 2010 through the present), governed the supervision of deferred VA purchase and exchange transactions.

(b) that a registered principal only approve VA transactions that he or she has determined that there is a reasonable basis to believe that the transaction is suitable for the customer; (3) failed to implement surveillance procedures to monitor associated persons' recommended rates of exchanges of VAs to identify inappropriate exchanges, in violation of NASD Rule 2821(d) and FINRA Rule 2330(d); (4) failed to have policies and procedures reasonably designed to implement corrective measures to address inappropriate VA exchanges and the conduct of associated persons who engage in inappropriate exchanges, in further violation of NASD Rule 2821(d) and FINRA Rule 2330(d); and (5) failed to develop and document specific training policies or programs to ensure that registered principals who reviewed VA transactions had adequate knowledge to monitor the transactions for compliance with FINRA rules, in violation of NASD Rule 2821(e) and FINRA Rule 2330(e).

RESPONDENT AND JURISDICTION

2. SWS is currently, and was during all times relevant hereto, a member of FINRA and the Municipal Securities Rulemaking Board ("MSRB"). The firm is also registered as a broker/dealer with the Securities and Exchange Commission. SWS registered with FINRA in April 1986 as a full service broker-dealer and is headquartered in Dallas, Texas. The firm employs 313 registered personnel, consisting primarily of registered representatives located in offices of supervisory jurisdiction ("OSJ") and single-person, non-OSJ offices throughout the United States. SWS currently operates 189 branch offices. From September 2009 to May 2011, SWS derived most of its revenue from the sale of equities, mutual funds, variable life insurance or annuities, and municipal securities.

3. FINRA retains jurisdiction over SWS because it is currently registered as a FINRA member firm.

FACTS

A. Introduction

4. During the period from September 2009 to May 2011, SWS derived 16% to 20% of its total revenues from the offer and sale of VAs to its customers. Notwithstanding the fact that VA sales accounted for a significant portion of the firm's overall securities business, SWS failed to establish and implement adequate supervisory systems and written supervisory procedures to supervise this aspect of its securities business.

5. SWS registered representatives who offered and sold VAs were located both in OSJ branch offices where a Series 24-registered branch manager was onsite, as well as in non-OSJ offices where there was no onsite supervisor. In accordance with the firms WSPs, VA transactions initiated by representatives in OSJ offices were reviewed and approved by the OSJ Branch Manager and then forwarded to SWS's home office for final review and approval by unregistered employees at affiliated insurance company Southwest Insurance Agency ("Insurance Agency").[2]

6. SWS's WSPs failed to set forth specific procedures for approval of VA transactions originating in non-OSJ offices. In practice, these transactions, which accounted for approximately 1,300 of the more than 1,500 VA transactions executed by SWS registered representatives during the review period, were sent directly from non-OSJ offices to Insurance Agency employees, BP or MF,[3] for initial review and approval. BP and MF were supposed to review the VA applications for completeness and conduct a preliminary suitability review. After

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[2] Insurance Agency acts as insurance agency for SWS.

[3] During the review period, BP and MF each held insurance and securities principal licenses with other entities. However, neither was registered with SWS *in any capacity*.

their review, the VA applications were then supposed to be sent to an SWS Regional OSJ Manager[4] for final suitability review and approval before being transmitted to the issuing insurance carrier for processing. SWS routinely failed to follow this unwritten process.

7. SWS's failure to establish and maintain WSPs that were specifically tailored to its VA securities business caused the firm to submit over 70%[5] of its non-OSJ initiated VA applications to the issuing insurance company without the applications ever having been reviewed by an SWS securities principal.

8. Furthermore, when the VA applications were eventually reviewed by SWS securities principals, the supervisory reviews were deficient in numerous respects. This was due, in part, to the fact that the firm failed to develop specific training policies or programs to ensure that registered principals who reviewed VA transactions had adequate knowledge to monitor for compliance with FINRA rules.

9. Finally, SWS failed to develop surveillance procedures to monitor its registered representatives' recommended rates of exchanges of VAs in order to detect inappropriate exchanges, and failed to have policies and procedures in place for corrective measures to address any inappropriate exchanges and the conduct of registered representatives who engaged in inappropriate exchanges.

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[4] Regional OSJ Managers are home office SWS securities principals who are responsible for supervising registered representatives located in non-OSJ offices. The transactions at issue in this matter were supervised by Regional OSJ Managers KR, who supervised the VA transactions of registered representative NV, and DN, who supervised the VA transactions of registered representative LN.

[5] Forty-three of sixty VA applications reviewed by FINRA staff were transmitted to the issuing insurance company without ever having been reviewed by an SWS securities principal.

B. **Suitability Reviews of Variable Annuity Transactions Performed by Unregistered Insurance Agency Employees Were Inadequate.**

10. Rather than fulfilling its own supervisory responsibilities, SWS relied on unregistered Insurance Agency employees to conduct primary suitability reviews of the VA transactions recommended by registered representatives located in non-OSJ offices. However, the reviews performed by the Insurance Agency employees were inadequate. For example, the Insurance Agency employees failed to review VA prospectuses to verify terms and cost of VAs, riders and other features in connection with their review of VA applications. When available, Insurance Agency employees generally relied only on Ernst & Young reports ("E&Y reports")[6] when conducting reviews of VA transactions.

11. In those instances where an E&Y report was not available, Insurance Agency employees relied upon registered representatives to contact the issuing insurance company to get any needed information instead of contacting the companies themselves.

12. Furthermore, instead of reaching out directly to customers if there was a question regarding a customer's wishes or understanding of the VA transaction at issue, the Insurance Agency employees relied exclusively on the registered representative's explanations for the customer's rationale for the purchase or exchange.

13. Insurance Agency employees also failed to review customers' other securities holdings in connection with their review of VA applications. The Insurance Agency employees only considered the amount of the customer's liquid net worth and, for new purchases, the source of funds. Consequently, Insurance Agency employees did not review or consider the customer's level of concentration in VAs or the nature of the customer's other securities holdings.

[6] E&Y reports provide overviews of the key features of certain VAs.

14. Likewise, Insurance Agency employees failed to actively monitor the rates of VA exchanges by SWS registered representatives in order to detect possible patterns of improper VA exchange recommendations. Although the Insurance Agency maintained a database of all exchange transactions recommended by each SWS registered representative in a given year, the databases were not linked and did not look for trends or patterns across multiple years. Moreover, Insurance Agency employees generally only checked the database once per year and not in connection with each VA transaction review. The annual exchange databases were utilized exclusively by Insurance Agency employees, and were not accessible to SWS securities principals.

C. SWS Violated NASD Rules 2821(c) and 3010 and FINRA Rule 2330(c) by Performing Inadequate Supervisory Reviews of Variable Annuity Transactions.

15. NASD Rule 2821(c) and FINRA Rule 2330(c) require that a registered principal "approve the recommended [VA] transaction only if he or she has determined that there is a reasonable basis to believe that the transaction would be suitable..."

16. In many instances, the Regional OSJ Managers did not have a reasonable basis to believe that certain VA transactions that they approved were in fact suitable for the customers. The Regional OSJ Managers failed to perform any independent supervisory reviews of VA transactions. Instead, they relied exclusively on information collected by the unregistered Insurance Agency personnel in making their suitability determinations.

17. Even when the Regional OSJ Managers had questions about the appropriateness or rationale for certain VA transactions, they did nothing to gain an independent understanding of the transactions. For example, Regional OSJ Managers KR and DN generally did not contact registered representatives to question them about the rationale for transactions and did not

contact customers to ascertain their understanding of the recommended transactions. Likewise, KR and DN did not review prospectuses and typically did not review the customer's other securities holdings in connection with their supervisory reviews of VA transactions. KR and DN inaccurately assumed that each of these functions was being performed by Insurance Agency employees prior to the VA application being submitted for SWS principal approval.

18. Furthermore, KR and DN did not monitor, and in fact had no way of monitoring, the VA exchange activity of the approximately 70 registered representatives that they each supervised. Although the Insurance Agency maintained annual databases of VA exchange transactions recommended by SWS registered representatives, the Regional OSJ Managers did not have access to the databases. Thus, the exchange data was not utilized in the Regional OSJ Managers' supervisory reviews.

19. The Regional OSJ Managers were not informed when transactions recommended by registered representatives that they supervised had been rejected by Insurance Agency employees. If a non-OSJ initiated VA application was rejected by an Insurance Agency employee, the application was never sent to an SWS securities principal for review. According to Insurance Agency employee BP, Insurance Agency kept a log of all rejected transactions. However, BP admitted that the log was never shared with the Regional OSJ Managers.

20. Regional OSJ Managers KR and DN both stated that they were *required* by SWS management to utilize the unregistered insurance employees as "resources" in connection with their supervisory reviews of VA transactions. KR and DN both felt as though they could not contradict suitability decisions made by the Insurance Agency employees despite their purported supervisory authority. In fact, KR resigned from SWS due, in part, to concerns about the amount of influence that the Insurance Agency employees had over the VA review and approval process.

21. Similarly, DN noted that there were instances in which she determined that a proposed VA transaction was unsuitable, and Insurance Agency employees went over her head to the National Sales Supervisor to challenge her determination. In those instances, the National Sales Supervisor conducted the suitability review and ultimately approved each of the transactions.

D. SWS Failed to Have All Variable Annuity Applications Reviewed and Approved by a Securities Principal Prior to Transmitting the Applications to the Issuing Insurance Companies for Processing.

22. NASD Rule 2821(c) and FINRA Rule 2330(c) also require that prior to transmitting a customer's application for a deferred VA to the issuing insurance company for processing, a registered principal shall review and determine whether he or she approves of the recommended purchase or exchange of the deferred VA.

23. SWS ignored this requirement in more than 70% of its non-OSJ initiated VA transactions during the relevant time period. Specifically, in connection with at least 43 of the 60 non-OSJ initiated VA transactions reviewed by FINRA staff, the application was transmitted to the issuing insurance company for processing after having only been reviewed by an unregistered Insurance Agency employee.

E. SWS Failed to Have Adequate Supervisory Systems and Written Supervisory Procedures to Supervise its Variable Annuities Securities Business.

24. SWS's WSPs regarding the supervision of VA transactions were deficient in many respects. The firm's WSPs did not address the difference in the approval process for non-OSJ initiated VA transactions. For example, the firm's procedures regarding new VA purchases required OSJ Branch Managers to review the VA application and *Customer Profile Form* and sign the *Branch Manager Suitability Review Form* prior to the VA application being sent to

Insurance Agency for review. The WSPs made no mention of the process for non-OSJ initiated transactions. In practice, the non-OSJ initiated transactions were not approved by a principal before being sent to Insurance Agency because there was no branch manager for non-OSJ sites and the WSPs did not require review by the Regional OSJ Managers before submission of the transactions to the issuing insurance company.

25. For replacement (e.g., exchanges) VA transactions, the WSPs required that the VA application be signed by the customer, registered representative and the registered representative's supervisor prior to sending the application to Insurance Agency for review. Again, the WSPs did not specifically address how non-OSJ initiated transactions should be handled and the non-OSJ representatives' supervisors were not reviewing and signing exchange applications prior to the applications being sent to Insurance Agency.

26. In addition, SWS's supervisory systems failed to ensure that an appropriate review of VA transactions was conducted. SWS's bifurcated system for the review and approval of non-OSJ initiated VA transactions caused confusion over responsibilities by the Insurance Agency employees and the Regional OSJ Managers. As a result, neither Insurance Agency employees nor the Regional OSJ Managers conducted adequate, comprehensive suitability reviews of VA transactions. The deficient reviews permitted several questionable transactions to be approved without adequate supervisory reviews.

a. Registered Representative NV's questionable transactions.

27. In connection with reviews of VA exchange transactions recommended by registered representative NV, Insurance Agency employees and Regional OSJ Manager KR failed to adequately investigate the appropriateness of the VA exchanges. Specifically, Insurance Agency employees and KR failed to verify NV's explanation that he caused twenty-

nine of his customers to exchange VAs issued by MassMutual Life Insurance Company for VAs issued by Jackson National Life Insurance because MassMutual would no longer issue certain living benefits in the form of guaranteed income riders. Neither the Insurance Agency employees nor KR reviewed the MassMutual prospectuses to determine the terms for the living benefits at the time that NV initially recommended the MassMutual VAs to his customers. Moreover, neither Insurance Agency employees nor KR contacted MassMutual to verify NV's claims that the company would cease offering the living benefits.

28. At least 3 of the 29 VA exchanges recommended by NV may have been unsuitable for the customers because, while NV purportedly recommended the exchanges so that the customer could obtain a living benefit that was no longer offered by MassMutual, none of the three customers was eligible to add a living benefit offered by Jackson National because they had not yet reached the required minimum age of 45 to add such benefits. Each of these customers incurred surrender charges and went into a VA contract with higher annual expenses, which may have been avoided in part if they had waited until age 45 to exchange their VA.

29. The Insurance Agency employee, BP, relied exclusively on NV's explanations for the transactions in connection with her reviews and approvals of the transactions, and failed to take any other action to confirm the suitability of the transactions for the customers. Likewise, although Regional OSJ Manager KR had concerns about NV's mass transfer of several customers from one VA to another, the only thing that he did to address his concerns was to talk to BP. KR relied on BP's explanations for the transactions (as they had been explained to her by NV) and failed to independently investigate NV's claims or perform any further inquiry into the appropriateness of the transactions.

b. Registered Representative LN's questionable transactions.

30. In connection with reviews of at least eleven VA exchange transactions recommended by registered representative LN, Insurance Agency employees and Regional OSJ Manager DN failed to adequately investigate the appropriateness of the exchanges. Specifically, Insurance Agency employees and DN failed to investigate and document: (1) the customer's understanding and acceptance of losses in income and death benefits; (2) the justification for the customer incurring surrender charges; and (3) the justification for the higher annual expenses that the customer would incur or the customer's high concentration in VAs.

31. In each of the 11 instances, there was no evidence indicating that an Insurance Agency employee or DN did anything to investigate LN's explanations for the recommended exchanges. It appears that the Insurance Agency employees simply relied on LN's explanation without any investigation of her claims. DN, as LN's supervisor, failed to conduct any independent investigation of LN's claims. Instead, she relied on reviews conducted by Insurance Agency employees.

F. SWS Failed to Have Surveillance Procedures in Place to Monitor Registered Representatives' Rates of Exchanges.

32. NASD Rule 2821(d) and FINRA Rule 2330(d) state that member firms must implement surveillance procedures "to determine if any of the member's associated persons have rates of effecting deferred VA exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of [NASD Rule 2821 and FINRA Rule 2330], other applicable FINRA rules, or the federal securities laws ("inappropriate exchanges"). NASD Rule 2821(d) and FINRA Rule 2330(d) also require member firms to "have policies and procedures reasonably designed to implement corrective measures to address

inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges."

33. SWS's WSPs state that the manager of the Insurance Agency, OSJ Managers and Branch Managers each have the responsibility to "identify [registered representatives] whose customers have a high rate of variable annuity replacements... and determine whether the replacement or rollovers are appropriate for the customers." However, the WSPs failed to address the means by which the supervisors were to identify inappropriate exchanges. Furthermore, the WSPs failed to address what corrective measures should be taken if inappropriate exchanges were identified or what actions should be taken against a registered representative who engaged in inappropriate exchanges.

34. SWS failed to implement surveillance procedures to determine if any of its registered representatives engaged in inappropriate exchanges. For example, the firm failed to utilize exception reports or other surveillance reports for VA transactions. The only system that the firm had in place to monitor exchanges was the annual databases maintained by the Insurance Agency regarding exchange transactions by SWS's registered representatives. The databases were ineffective as a surveillance tool because they were not automated and could not monitor or identify trends or patterns of suspicious VA exchanges. Furthermore, Insurance Agency employees did not routinely monitor the databases and the Regional OSJ Managers did not have access to the databases to utilize in connections with their suitability reviews of VA transactions. Accordingly, during the review period, the firm effectively had no system in place to monitor the more than 1,500 VA transactions executed by 128 registered representatives for inappropriate exchanges.

G. SWS Failed to Provide the Securities Principals who Reviewed VA Transactions with Adequate Training to Ensure Compliance with NASD Rule 2821 and FINRA Rule 2330.

35. NASD Rule 2821(e) and FINRA Rule 2330(e) require members to "develop and document specific training policies or programs reasonably designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of [NASD Rule 2821 and FINRA Rule 2330] and that they understand the material features of [VAs]...."

36. SWS failed to develop and document specific training policies or programs to comply with the requirements of NASD Rule 2821(e) and FINRA Rule 2330(e). In fact, the firm had no *specific* training policies or programs in place for the securities principals who had responsibility for reviewing and approving VA transactions. For example, the training for new Regional OSJ Managers consisted of them shadowing a current Regional OSJ Manager and observing how that manager performed his or her job functions. Much of this training was operational in nature and focused on familiarizing the new Regional OSJ Manager with SWS's various computer systems. The Regional OSJ Managers did not receive any specific training regarding how to conduct suitability reviews of VA transactions.

37. According to the National Sales Supervisor, who was responsible for supervising the Regional OSJ Managers, training regarding VAs consisted of two RegEd[7] courses, one of which generally focused on NASD Rule 2821. He further indicated that the Regional OSJ Managers attended sales conferences organized by the Insurance Agency where VA wholesalers came in and made presentations regarding certain VA products.

[7] RegEd is the firm's computerized training provider.

38. None of the purported training identified by the National Sales Supervisor was documented in any of SWS's policies or WSPs.

FIRST CAUSE OF ACTION
INADEQUATE SUPERVISORY SYSTEMS AND WRITTEN SUPERVISORY PROCEDURES TO SUPERVISE VARIABLE ANNUITY SECURITIES BUSINESS

(NASD Rule 3010, NASD Rule 2821(d) (for conduct on or before February 7, 2010), FINRA Rule 2330(d) (for conduct on or after February 8, 2010), and FINRA Rule 2010)

39. The Department realleges and incorporates by reference paragraphs 1-38 above.

40. During the period from September 2009 to May 2011, as alleged in paragraphs 4-38, SWS failed to establish and maintain specific supervisory systems and WSPs that were reasonably designed to achieve compliance with the standards set forth in NASD Rule 2821(d) and FINRA Rule 2330(d). Moreover, these failures also caused SWS to fail to comply with the general supervisory requirements of NASD Rule 3010.

41. As a result of the foregoing conduct, Respondent SWS violated NASD Rule 3010, NASD Rule 2821(d) (for conduct on or before February 7, 2010), FINRA Rule 2330(d) (for conduct on or after February 8, 2010) and FINRA Rule 2010.

SECOND CAUSE OF ACTION
INADEQUATE SUPERVISORY REVIEWS OF VARIABLE ANNUITY TRANSACTIONS

(NASD Rule 3010, NASD Rule 2821(c) (for conduct on or before February 7, 2010), FINRA Rule 2330(c) (for conduct on or after February 8, 2010), and FINRA Rule 2010)

42. The Department realleges and incorporates by reference paragraphs 1-41 above.

43. In connection with VA transactions recommended by SWS registered representatives during the period from September 2009 to May 2011, as alleged in paragraphs

15-21 and 26-31, SWS securities principals did not have a reasonable basis to believe that certain of the transactions that they approved were in fact suitable for the customers.

44. As a result of the foregoing conduct, Respondent SWS violated NASD Rule 3010, NASD Rule 2821(c) (for conduct on or before February 7, 2010), FINRA Rule 2330(c) (for conduct on or after February 8, 2010) and FINRA Rule 2010.

THIRD CAUSE OF ACTION

FAILURE TO HAVE REGISTERED PRINCIPAL REVIEW OF DEFERRED VARIABLE ANNUITY TRANSACTIONS PRIOR TO TRANSMISSION TO THE ISSUING INSURANCE COMPANY FOR PROCESSING

(NASD Rule 2821(c) (for conduct on or before February 7, 2010), FINRA Rule 2330(c) (for conduct on or after February 8, 2010), and FINRA Rule 2010)

45. The Department realleges and incorporates by reference paragraphs 1-44 above.

46. During the period from September 2009 to May 2011, as alleged in paragraphs 22-23, in at least 43 instances SWS failed have a registered principal review and determine whether he or she approved of the recommended purchase or exchange of the deferred VA prior to the transmission of the customer's application for the deferred VA to the issuing insurance company for processing.

47. As a result of the foregoing conduct, Respondent SWS violated NASD Rule 2821(c) (for conduct on or before February 7, 2010), FINRA Rule 2330(c) (for conduct on or after February 8, 2010) and FINRA Rule 2010.

FOURTH CAUSE OF ACTION

FAILURE TO HAVE SURVEILLANCE PROCEDURES TO DETECT INAPPROPRIATE VARIABLE ANNUITY EXCHANGES

(NASD Rule 2821(d) (for conduct on or before February 7, 2010), FINRA Rule 2330(d) (for conduct on or after February 8, 2010), and FINRA Rule 2010)

48. The Department realleges and incorporates by reference paragraphs 1-47 above.

49. During the period from September 2009 to May 2011, as alleged in paragraphs 32-34, SWS failed to implement surveillance procedures to determine if any of its associated persons had rates of effecting deferred VA exchanges that raised for review whether such rates of exchanges evidenced conduct inconsistent with the applicable provisions of NASD Rule 2821and FINRA Rule 2330, other applicable FINRA rules, or the federal securities laws ("inappropriate exchanges"). SWS also failed to have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges.

50. As a result of the foregoing conduct, Respondent SWS violated NASD Rule 2821(d) (for conduct on or before February 7, 2010), FINRA Rule 2330(d) (for conduct on or after February 8, 2010) and FINRA Rule 2010.

FIFTH CAUSE OF ACTION

FAILURE TO DEVELOP AND DOCUMENT SPECIFIC TRAINING PLAN FOR SUPERVISORY REVIEW OF VARIABLE ANNUITY TRANSACTIONS

(NASD Rule 2821(e) (for conduct on or before February 7, 2010), FINRA Rule 2330(e) (for conduct on or after February 8, 2010), and FINRA Rule 2010)

51. The Department realleges and incorporates by reference paragraphs 1-50 above.

52. During the period from September 2009 to May 2011, as alleged in paragraphs 35-38, SWS failed to develop and document specific training policies or programs to ensure that

registered principals who reviewed VA transactions had adequate knowledge to monitor for compliance with FINRA rules.

53. As a result of the foregoing conduct, Respondent SWS violated NASD Rule 2821(e) (for conduct on or before February 7, 2010), FINRA Rule 2330(e) (for conduct on or after February 8, 2010) and FINRA Rule 2010.

RELIEF REQUESTED

WHEREFORE, the Department respectfully requests that the Panel:

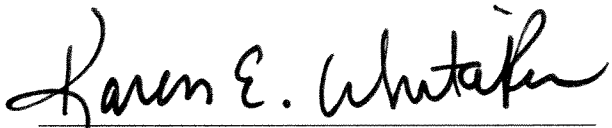
A. make findings of fact and conclusions of law that Respondent committed the violations charged and alleged herein;

B. order that one or more of the sanctions provided under FINRA Rule 8310(a), including monetary sanctions, be imposed; and

C. order that Respondent bear such costs of proceeding as are deemed fair and appropriate under the circumstances in accordance with FINRA Rule 8330.

FINRA DEPARTMENT OF ENFORCEMENT

Date: September 29, 2014



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