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 Hearing Officer—David M. FitzGerald **EXTENDED HEARING PANEL DECISION** August 13, 2015

Respondent's supervision of deferred variable annuity transactions did not comply with the requirements of FINRA Rule 2330 in certain respects, and Respondent thereby violated FINRA Rules 2330 and 2010 and NASD Rule 3010. For these violations, Respondent is fined $50,000 and ordered to pay costs. The Department of Enforcement did not prove other violations of Rule 2330 and NASD Rule 2821(e) alleged in the Complaint by a preponderance of the evidence, and accordingly those charges are dismissed.

Appearances

Karen E. Whitaker, Esq., Steve Graham, Esq., Penelope Brobst Blackwell, Esq. and David B. Klafter, Esq. for the Department of Enforcement.

Tim Chastain, Esq. and Alex More, Esq., Carrington, Coleman, Sloman & Blumenthal, L.L.P., for the Respondent.

DECISION

I. Introduction

This case concerns the obligations of a FINRA member firm in supervising deferred variable annuity ("VA") transactions recommended by its registered representatives ("RRs"). FINRA Rule 2330, entitled "Members' Responsibilities Regarding Deferred Variable Annuities" requires, *inter alia*, that FINRA member firms "must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in [Rule 2330]." It further requires that "[p]rior to transmitting a customer's application for a deferred variable annuity 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 variable annuity." The Rule provides that "[a] registered principal shall approve the recommended transaction only if he or she has determined that there is a reasonable basis to believe that the transaction would be suitable [for the customer]."

In addition, to assist in the firm's oversight of VA transactions, FINRA Rule 2330 requires that the firm "implement surveillance procedures to determine if any of the member's associated persons have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with applicable provisions of this Rule, other applicable FINRA rules, or the federal securities laws ...." The Rule also requires that firms "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." Finally, Rule 2330 requires firms "to develop and document specific training policies or programs reasonably designed to ensure that ... registered principals who review transactions in deferred variable annuities comply with the requirements of this Rule and that they understand the material features of deferred annuities ...."

On September 29, 2014, FINRA's Department of Enforcement filed a five-cause Complaint against FINRA member firm SWS Financial Services, Inc., relating to its oversight of VA transactions.[1] The Complaint alleged that during the Relevant Period:[2]

(1) SWS's supervisory system and written supervisory procedures ("WSPs") were not reasonably designed to achieve compliance with the standards set forth in Rule 2330, as required

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[1] The allegations set forth in Enforcement's Complaint were clarified and amended by Enforcement in its Amended Bill of Particulars filed on January 21, 2015. The description of the charges in the Complaint set forth in this Decision reflects those clarifications and amendments.

[2] The Complaint alleged that the "review period" was from September 2009 to May 2011, but the parties stipulated, more specifically, that the "Relevant Period" for this matter is September 16, 2009 to May 15, 2011. *See* Joint Agreed Stipulations ("Stip.") ¶ 1. Rule 2330, however, did not become effective until February 8, 2010. To address the period from September 16, 2009, to February 8, 2010, the first four causes of the Complaint cited subsections (c) and (d) of NASD Rule 2821, which paralleled the same subsections of Rule 2330, while the fifth cause cited NASD Rule 2821(e), which paralleled Rule 2330(e). Subsections (c) and (d) of Rule 2821, however, never became effective. Instead, although the rest of Rule 2821 became effective on May 5, 2008, the Securities and Exchange Commission, at FINRA's request, delayed the effective date of subsections (c) and (d) of the Rule. *See* Exchange Act Release No. 57769, 2008 SEC LEXIS 1017 (May 2, 2008). Ultimately, the substance of subsections (c) and (d) of Rule 2821 became subsections (c) and (d) of Rule 2330, which as noted above became effective on February 8, 2010. *See* Exchange Act Release No. 59772, 2009 SEC LEXIS 1297 (Apr. 15, 2009); FINRA Regulatory Notice No. 09-72 (Dec. 2009), http://www.finra.org/industry/notices/09-72.

Apparently in belated recognition of these facts, in the Amended Bill of Particulars Enforcement withdrew the Complaint's allegations regarding Rules 2821(c) and (d) in the first four causes of the Complaint, while keeping its allegations regarding Rule 2821(e) in the fifth cause of the Complaint. Therefore, for purposes of this Decision, the Relevant Period for causes one through four of the Complaint is from February 8, 2010, to May 15, 2011, while the Relevant Period for purposes of cause five of the Complaint is September 16, 2009, to May 15, 2011. *See* Stip. ¶¶ 1-2.

by 2330(d), and therefore also failed to comply with the general supervisory requirements set forth in NASD Rule 3010;

(2) the SWS principals who reviewed 13 specific VA transactions did not have a reasonable basis to believe the transactions would be suitable for the customers, as required by Rule 2330(c), and by the general supervisory requirements in NASD Rule 3010;

(3) 38 specific VA applications were sent to the issuing insurance companies prior to review by a registered principal, in violation of Rule 2330(c);

(4) the firm did not implement surveillance procedures to monitor its associated persons' rates of effecting VA exchanges, or have policies and procedures to correct inappropriate exchanges and the conduct of associated persons who engaged in inappropriate exchanges, as required by Rule 2330(d); and

(5) SWS did not develop and document specific training policies or programs reasonably designed to ensure that registered principals who reviewed VA transactions had adequate knowledge to monitor for compliance with FINRA rules, in violation of NASD Rule 2821(e), for the portion of the Relevant Period prior to February 8, 2010, and Rule 2330(e), for the portion of the Relevant Period subsequent to February 8, 2010.[3]

To establish these alleged violations, Enforcement was required to prove the allegations of the Complaint by a preponderance of the evidence. *See, e.g.*, *David M. Levine*, 57 S.E.C. 50, 73 n.42 (2003).

A hearing was held on the charges in the Complaint from May 12 through May 15, 2015. The Extended Hearing Panel heard testimony from six witnesses and received numerous exhibits in evidence, including excerpts from on-the-record interviews ("OTRs") that Enforcement obtained from three additional individuals during its investigation. The Extended Hearing Panel also considered joint stipulations of the parties; comprehensive pre-hearing briefs filed by the parties; and the parties' closing arguments. Based on a careful consideration of all this evidence and argument, the Extended Hearing Panel concludes that:

(1) SWS's supervisory system and its WSPs during the Relevant Period were not reasonably designed to achieve compliance with the standards set forth in Rule 2330 because the WSPs failed to set forth adequately the suitability review process for certain VA transactions and the time for transmitting VA applications to the issuing insurer;

[3] Enforcement's investigation leading to the filing of the Complaint arose out of a routine cycle examination of SWS performed by FINRA in 2011. The examination focused, in part, on the firm's compliance with the requirements of FINRA Rule 2330. The Relevant Period was established for purposes of that examination. Tr. 697-704.

(2) Enforcement did not prove, by a preponderance of the evidence, that the SWS principals who reviewed the 13 specific VA transactions cited by Enforcement lacked a reasonable basis to believe that the transactions were suitable for the customers;

(3) the 38 specific VA applications cited by Enforcement were forwarded to the issuing insurance companies for processing prior to the completion of the required suitability review;

(4) SWS failed to implement adequate surveillance procedures during the Relevant Period to monitor its RRs' rates of effecting VA exchanges, but Enforcement did not prove, by a preponderance of the evidence, that SWS lacked policies or procedures reasonably designed to implement corrective measures to address inappropriate exchanges or the conduct of associated persons who engaged in inappropriate exchanges; and

(5) Enforcement did not prove by a preponderance of the evidence that SWS failed to develop and document adequate training policies and procedures for SWS principals who reviewed VA transactions.

Accordingly, the Extended Hearing Panel finds that SWS violated FINRA Rules 2330(d) and 2010 and NASD Rule 3010, as alleged in the first cause of the Complaint; violated FINRA Rules 2330(c) and 2010 as alleged in the third cause of the Complaint; and, in certain respects, violated FINRA Rules 2330(d) and 2010 as alleged in the fourth cause of the Complaint. The remaining charges will be dismissed.

II. Facts

A. Respondent

SWS is, and during the Relevant Period was, a FINRA member firm. During the Relevant Period, SWS was under common holding company ownership with another FINRA member firm, Southwest Securities, Inc., and a captive insurance agency, Southwest Insurance Agency (the "Insurance Agency"). Neither SWS nor the Insurance Agency had any employees. Rather, all in-house staff of those entities were employees of Southwest Securities and in some cases they performed services for more than one of the entities owned by the holding company.[4]

SWS had more than 300 registered persons consisting primarily of independent contractor RRs who worked either in multi-RR branch Offices of Supervisory Jurisdiction ("OSJs") or in single RR non-OSJ offices throughout the United States. RRs in branch offices were supervised by on-site managers who were registered as principals through SWS. Those managers, in turn, were supervised by registered principal Regional OSJ Managers who were located in SWS's Dallas, Texas, main office. In contrast, non-OSJ RRs were supervised directly

[4] Complainant's Exhibit ("CX")-1; Hearing Transcript ("Tr.") 688-89.

by the Regional OSJ Managers.[5] During the Relevant Period, there were four Regional OSJ Managers, each of whom supervised approximately 70 RRs.[6]

Among other things, SWS RRs sold VAs to SWS customers. In 2009, 2010 and 2011, SWS's gross revenues were $30.9 million, $37.7 million and $39.9 million, respectively. SWS's gross revenues from VA transactions during these years were $4,367,193.89 in 2009 (14% of gross revenue); $6,180,501 in 2010 (16% of gross revenue) and $7,955,790 in 2011 (20% of gross revenue).[7] During the Relevant Period, SWS had a total of 1,542 VA transactions, 956 of which were recommended by just ten RRs. In fact, five RRs accounted for 749 of the transactions.[8]

B. Respondent's Review of VA Transactions

SWS's procedures for review of VA transactions varied depending on whether they originated from an OSJ branch office or from a non-OSJ RR. For VA transactions originating in OSJ branch offices, the on-site manager/principal reviewed each transaction for, *inter alia*, its suitability for the customer. If the on-site manager/principal approved the transaction, it was transmitted to the Insurance Agency, where it was reviewed by Insurance Agency compliance staff. The Insurance Agency staff reviewed the application to identify any technical deficiencies, but also conducted a second suitability review of the VA transaction before transmitting the VA application to the insurer.[9] The charges in the Complaint do not relate to the review of VA transactions from branch offices, and accordingly the Extended Hearing Panel expresses no views regarding those procedures.

For transactions recommended by a non-OSJ RR, the originating RR sent the VA application directly to the Insurance Agency where it was reviewed by Insurance Agency compliance staff prior to a second review by a Regional OSJ Manager.[10] All of the charges in the Complaint relate to SWS's oversight of VA transactions originated by non-OSJ RRs during the Relevant Period.

The Insurance Agency compliance staff consisted of two individuals, Barbara Pittman, the compliance supervisor, and Maricelda Castillo Franco. Both Pittman and Franco had substantial knowledge regarding VAs and experience in reviewing VA transactions, and both were qualified principals. Both were registered as principals of Southwest Securities, but neither

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[5] Stip. ¶ 3. The non-OSJ RRs worked out of their own individual offices or their homes. Tr. 128.

[6] Tr. 128, 200-202; Stip. ¶¶ 6-7. The branch offices were generally pre-existing operations, with an established manager/principal, when the RRs became affiliated with SWS. Tr. 262-63.

[7] Stip. ¶ 4.

[8] Stip. ¶ 5; Respondent's Exhibit ("RX")-1.

[9] Stip. ¶ 9; Tr. 279-81.

[10] Tr. 281-82; Stip. ¶ 10; Tr. 33-34; Joint Exhibit ("JX")-21, at 5; JX-22, at 2.

was registered as a principal of SWS. Pittman, Franco and Mike Cogliano,[11] SWS's Chief Compliance Officer, gave unrebutted testimony at the hearing that Pittman, Franco and SWS believed that Pittman and Franco were registered with SWS as well as Southwest Securities, and that the failure to register them was an oversight. Both Pittman and Franco registered as SWS principals when Enforcement pointed out to SWS, during the investigation, that they were not registered.[12]

When Pittman and Franco received a VA application from a non-OSJ RR, they reviewed it for both technical VA-related issues and for suitability of the proposed transaction for the customer.[13] To assist them in their review, the VA application was contained in a "package" that included SWS proprietary compliance documents, as well as relevant correspondence and other documents compiled by the submitting RR. Pittman and Franco reviewed the VA application package, in some cases directing oral or written questions to the RR or conducting independent research regarding the VA to be purchased. If they relied on additional information to evaluate the proposed VA, they included that information in the application package.[14]

If Pittman or Franco rejected a VA application from a non-OSJ RR, it went no farther in the approval process.[15] If they approved a VA application, however, they delivered the VA application package to the Regional OSJ Manager who supervised the RR who had submitted it. The package they delivered included a cover sheet summarizing the transaction and reflecting their approval. The Regional OSJ Manager then performed another review of the proposed transaction to evaluate whether it was suitable for the customer, utilizing the information contained in the VA application package.[16] If the Regional OSJ Manager approved the VA transaction as suitable, the approval was reflected on another SWS compliance form included in the VA application package. All of the witnesses who addressed the issue testified that the suitability review conducted by Pittman and Franco was preliminary, and that the review

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[11] Cogliano's name is misspelled as "Cobliano" in the hearing transcript.

[12] Stip. ¶ 11; Tr. 271-72, 513, 596, 611, 687; JX-1; JX-2. Pittman was qualified as a Series 26, Investment Company Products/Variable Contract Principal, while Franco was qualified as a Series 24, General Securities Principal. Either type of qualification was sufficient for a principal performing a suitability review pursuant to Rule 2330(c). *See* Rule 2330(a)(3).

[13] Tr. 276-77.

[14] *See, e.g.*, RX-59.

[15] If a VA application was rejected for technical reasons (for example, because the proposed VA was no longer available for purchase), the Regional OSJ Manager was not notified of the rejection. *See, e.g.*, RX-56 (rejecting VA application because the proposed VA product was no longer available from the insurance company). During the Relevant Period, Pittman and Franco rejected only one VA application on suitability grounds, and they notified the relevant Regional OSJ Manager of the rejection by copying him on the email notifying the RR of the rejection. RX-60.

[16] Tr. 35-36, 139-42.

performed by the Regional OSJ managers was intended to be the final, determinative suitability review for VA applications submitted by non-OSJ RRs.[17]

C. Suitability Review of Transactions Cited by Enforcement

In the Complaint, as modified by Enforcement's Amended Bill of Particulars, Enforcement alleged that the reviewing SWS principal lacked a reasonable basis to believe 13 specific VA transactions originating from non-OSJ RRs were suitable for the customers.[18] Each of the VA transactions identified by Enforcement had a VA application package that included, in addition to a completed VA application, various SWS compliance forms containing information regarding the proposed transaction, as well as supporting correspondence and documentation that varied from transaction to transaction.

Specifically, each VA application package included, as a cover sheet, a compliance form captioned "Insurance Compliance Notes." Among other things, this form identified the submitting RR and the customer; provided certain material information concerning the customer, such as the customer's age, net worth, liquid net worth, income, time horizon, objectives and risk tolerance; and provided information regarding the terms of the proposed VA. Each Insurance Compliance Notes form was signed and dated by the Insurance Agency principal who had reviewed the transaction.[19]

Next, each package included a "Variable Annuity Compliance Form." The first two pages, which were completed by the submitting RR, contained detailed information regarding the customer and disclosures made to the customer regarding VA investments, and each page was signed and dated by the customer. The third page, captioned "Annuity Exchange and Replacement Form," was completed by the submitting RR for every VA transaction involving an exchange of one VA for another VA. This form included a side-by-side comparison of the key provisions of both VAs, including the current market value of the existing VA and estimated market value of the new VA; existing VA surrender charges; surrender period remaining for each VA, including number of years and percentage surrender cost; any guaranteed period and fixed interest rate for each VA; the amount of any death benefit for each VA; the living benefit value of the current VA and the proposed VA; and the total annual charges for each VA. Following the comparison section, the submitting RR was required to complete a section asking, "How does this exchange benefit the client?" A final section required both the RR and the customer to initial the following statement: "We have confirmed with the existing carrier that the additional

[17] JX-21, at 5; JX-22, at 2; Tr. 34, 139, 293.

[18] CX-29; CX-30; CX-31; CX-36; CX-52; CX-55; CX-59; CX-60; CX-61; CX-62; CX-63; CX-64; CX-65.

[19] *See, e.g.*, CX-29, at 1.

benefits are not able to be added to the current contract." Both the RR and the customer were required to sign and date this page for every exchange.[20]

If the VA transaction did not involve an exchange, the RR completed the fourth page of the Variable Annuity Compliance Form, captioned "Annuity Purchase Form." This form included the same detailed information regarding the VA to be purchased, and required completion of a section headed, "The client's intentions for this variable annuity are." Once again, both the RR and the customer were required to sign and date this page for every non-exchange purchase of a new VA.[21]

The last page of the Variable Annuity Compliance Form required the submitting RR to sign a statement confirming, *inter alia*, that the RR was "satisfied this product, as purchased, is suitable for this client." The same page evidenced "Branch Manager/OSJ Suitability Review." Among other things, it required the reviewing principal to answer, "Does the VA create a potential liquidity problem(s) for the client during the surrender charge period?" If the reviewer answered "yes," the form required the reviewer to "explain your approval." In addition, the reviewing principal was required to address whether "the client's age [is] suitable for stated time horizon"; whether "the riders and options purchased [are] consistent for the client's goals and reasons given for the purchase of the VA"; and whether "the investment options (fixed and variable) chosen [are] consistent with the client's investment objective." If the transaction involved a replacement or exchange of another VA, the reviewing principal was required to list the surrender costs incurred by the customer and to answer whether the reviewer "agree[s] with the reasoning and economics of the exchange or transfer." If the contract included a bonus to the customer, the reviewing principal was required to answer whether "any additional charges or increased surrender periods [are] appropriate for the client." This portion of the form was completed, signed and dated by the reviewing Regional OSJ for 10 of the 13 VA transactions cited by Enforcement.[22]

As noted above, each VA application package included, in addition to SWS's compliance forms and the VA application, supporting documents that varied from transaction to transaction. For example, if the proposed transaction was an exchange, the supporting documentation typically included the latest statement for the VA that was being exchanged. In some cases, the package included documents such as correspondence between a reviewing Insurance Agency principal and the submitting RR concerning questions raised by the Insurance Agency principal,

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[20] *See, e.g.*, CX-30, at 4. RRs were provided with Variable Annuity Compliance Form instructions and answers to frequently asked questions, as well as examples of properly completed forms. RX-6 through RX-8.

[21] *See, e.g.*, CX-29, at 5.

[22] *See, e.g.*, CX-29, at 6. The VA application packages that Enforcement submitted for the three VA transactions documented in CX-36, CX-59, and CX-60 did not include a Variable Annuity Compliance Form, but no explanation for the omission was offered by any party or any witness. Under these circumstances, the Extended Hearing Panel is unable to determine whether a Variable Annuity Compliance Form was, or was not, completed for those transactions.

or Ernst & Young research reports on the proposed VA obtained by the reviewing Insurance Agency principal, or correspondence between the proposed issuing insurance company and the RR regarding the terms of the proposed VA.[23]

D. Transmittal of VA Applications to Issuing Insurance Companies

In the Complaint, as modified by Enforcement's Amended Bill of Particulars, Enforcement alleged that 38 specific VA transactions originating from non-OSJ RRs were transmitted to the issuing insurance company prior to a suitability review by a Regional OSJ Manager.

Both Insurance Agency principals testified that during the Relevant Period, it was the Insurance Agency's routine practice to send VA applications to the issuing insurance companies once an Insurance Agency principal had completed her review, without waiting for the Regional OSJ Manager's suitability sign-off.[24] Indeed, the parties stipulated that, at Enforcement's request, SWS reviewed its VA transactions during the Relevant Period and determined that in 2010, 587 VA transactions, or 63.19% of SWS's total VA transactions, were submitted to the issuing insurance company prior to the approval of the Regional OSJ Manager. From January 1 through May 15, 2011, 275 VA transactions, or 71.61% of SWS's total VA transactions during that period, were submitted to the issuing insurance company prior to approval by the Regional OSJ Manager.[25]

The 38 VA transactions identified by Enforcement were among the VA applications transmitted to the issuing insurance companies prior to a suitability review by a Regional OSJ Manager. The Regional OSJ Manager suitability signoffs for those transactions occurred from one to 12 business days after the VA application was transmitted to the issuing insurance company.[26]

E. Surveillance Procedures and Corrective Measures

SWS's WSPs regarding insurance replacements, generally, indicated that it was the responsibility of "The Manager of Southwest Insurance Agency" and "Branch Manager/OSJ Manager" to, *inter alia*, "identify RRs whose customers have a high rate of variable annuity replacements or rollovers" and that this was to done "Daily or as required." But that portion of the WSPs did not explain how the identification would be accomplished.[27] During the Relevant Period, the Insurance Agency maintained a database of all VA transactions. SWS's WSPs

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[23] *See, e.g.*, CX-29, at 7-57.

[24] Tr. 350, 501.

[25] Stip. ¶ 12.

[26] CX-113; Tr. 708-09, 714-15.

[27] Stip. ¶ 15; JX-16, at 5.

regarding VA exchanges listed "Insurance Database reviewed to identify patterns including excessive exchanges" among the responsibilities of "The Supervisory Manager" and "The Manager of Southwest Insurance Agency." The WSPs indicate that this should be done "Daily, or as required."[28]

During the Relevant Period, the Insurance Database was not accessible by the Regional OSJ Managers. Rather, it was maintained by and available to only Insurance Agency employees. Moreover, the Insurance Database was not created to monitor exchange rates, but rather to collect a wide variety of information regarding VA applications. Indeed, the Insurance Database did not even collect information regarding whether a VA application was an exchange until 2010.[29] And although the parties stipulated that "Insurance Agency employees generally checked the exchange rates for VA transactions once per year," the Insurance Agency principals who reviewed VA transactions testified that they did not conduct any systematic, regular review of VA exchange rates during the Relevant Period.[30] Insofar as another Insurance Agency employee may have manually calculated VA exchange rate during the Relevant Period, those calculations were not shared with either the Regional OSJ Managers or the Insurance Agency principals who reviewed VA transactions.[31]

SWS's WSPs during the Relevant Period that addressed VA suitability reviews directed "Branch Manager/OSJ Manager" to "Rescind or block purchases where a purchase would be inappropriate."[32] In addition, the WSPs contained procedures to address inappropriate transactions effected by RRs, as well as procedures to address inappropriate conduct by RRs, regardless of the nature of the underlying transactions. Thus, SWS's WSPs concerning "Review of Daily Transactions" directed the "OSJ" to "take corrective action" for "orders contrary to Firm policy or rule requirements." Listed corrective actions included conferring with the RR to obtain additional information, canceling and rebilling the transaction, canceling the transaction to SWS's error account, or "Confer[ring] with Compliance regarding additional education for the RR or discipline."[33] And WSPs concerning "Internal Disciplinary Actions" provided that "[t]he Firm will, when appropriate, take disciplinary action against employee/RRs who engage in improper activities. Action may include, but is not limited to, training or other enhanced education, written reminders or reprimands, limitations on certain types of business, suspension, or termination."[34]

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[28] JX-16, at 10.

[29] Tr. 339. *Compare* JX-18 (2009 Insurance Database, with no provision for indicating exchanges) *with* JX-19 and JX-20 (Insurance Databases for 2010 and 2011, with a column indicating whether a VA was a "Replacement.")

[30] Stip. ¶ 16; Tr. 339-40.

[31] Tr. 335.

[32] JX-16, at 10-11.

[33] JX-17, at 119-20.

[34] JX-17, at 15.

F. Training

SWS required all associated persons, including both RRs and principals, to take a standard computer-based course on VA transactions and the FINRA rules relating to such transactions before recommending or reviewing any VA transaction. Each Regional OSJ Manager took the required course prior to or during the Relevant Period.[35] The required course reviewed the FINRA rules and requirements for VA sales.[36]

In addition, newly hired Regional OSJ Managers were required to review the Firm's WSPs, including those addressing VA transactions. They also met with the Insurance Agency staff to obtain additional information about VAs, were encouraged to attend programs put on by the Insurance Department regarding VA products, and were required to take at least one supervisory training program each year, some of which had a VA component.[37]

Most training for new Regional OSJ Managers was informal. SWS had a practice of hiring experienced principals for the Regional OSJ Manager positions. The two Regional OSJ Managers whose suitability reviews are at issue in this proceeding both had substantial experience reviewing the suitability of VA transactions with other FINRA member firms before being hired by SWS as Regional OSJ Managers. After being hired, new Regional OSJ Managers learned SWS's review procedures by working with experienced SWS Regional OSJ Managers.[38]

III. Discussion

A. Introduction

FINRA Rule 2330 was originally adopted as NASD Rule 2821 and became FINRA Rule 2330 as part of FINRA's rule consolidation process.[39] The Rule is unusual because it establishes specific standards for member firms' oversight of a particular type of securities product, VAs. As NASD explained in proposing Rule 2821:

> NASD has been concerned about deferred variable annuity transactions for some time. In part, this concern stems from the complexities of the products, which can cause confusion both for persons associated with members who sell deferred variable annuities and for customers who purchase or exchange them.

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[35] Stip. ¶¶ 19-20; RX-69 through RX-71; RX-75; Tr. 32-33, 146.

[36] JX-11; JX-12.

[37] Tr. 258-61, 635-36.

[38] Tr. 22-23, 27-28, 143-45.

[39] *See* Exchange Act Release No. 61122, 2009 SEC LEXIS 4017 (Dec. 7, 2009). There have been no substantive changes in Rule 2330 since the Relevant Period. The parties cited no prior disciplinary decisions interpreting or applying either Rule 2330 or NASD Rule 2821, and the Extended Hearing Panel has not found any such decisions.

Deferred variable annuities are hybrid investments containing both securities and insurance features. They offer choices among a number of complex contract features (e.g., deferred variable annuity contracts may offer various types of death benefits, rebalancing features, dollar cost averaging options, and optional riders such as a guaranteed minimum income benefit, estate protection enhancements, or long-term care insurance, in addition to a range of choices among investment options). The amount that will accumulate and be paid to the investor pursuant to a deferred variable annuity will fluctuate depending on the investment options that the investor chooses. Investors also can be subject to the following fees or charges: surrender charges (which the investor owes if he or she withdraws money from the annuity before a specified period); mortality and expense risk charges (which the insurance company charges for the insurance risk it takes under the contract); administrative fees (which are used for recordkeeping and other administrative expenses); underlying fund expenses (which relate to the investment options); and charges for special features and riders. Moreover, an investor's withdrawal of earnings before he or she reaches the age of 59½ is generally subject to a 10-percent penalty under the Internal Revenue Code.

In addition to the complexity of the product—and perhaps, in part, because of it—NASD examinations and investigations have uncovered various questionable sales practices. In some instances, associated persons sold deferred variable annuities to elderly customers for whom such long-term, illiquid products were not suitable. In others, associated persons sold deferred variable annuities without explaining (and, in some cases, without knowing) the characteristics of the products. On a number of occasions, associated persons recommended that customers exchange one deferred variable annuity for another without ensuring that such exchanges were beneficial for their customers or properly disclosing costs. NASD also determined that a number of firms had, in general, failed to adequately train and supervise associated persons regarding deferred variable annuity sales.[40]

B. Written Supervisory Procedures

FINRA Rule 2330(d) provides that "a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule." In the first cause of the Complaint, Enforcement alleged that SWS violated Rule 2330(d) because its WSPs were not reasonably designed to achieve compliance with the standards in Rule 2330. In addition, Enforcement alleged that the deficiencies in SWS's supervisory procedures for VA transactions also caused it to violate NASD Rule 3010, which

[40] Exchange Act Release No. 52046, 2005 SEC LEXIS 1754, at *2-6 (July 15, 2005) (footnote omitted).

required FINRA member firms to establish and maintain a supervisory system, including WSPs, reasonably designed to achieve compliance with applicable securities laws and regulations.[41]

SWS's WSPs included provisions setting forth detailed VA suitability considerations for both RRs and principals who were responsible for reviewing VA transactions.[42] The WSPs also outlined, in general terms, the sequence of the review process for a VA transaction originating in an OSJ branch office, which entailed approval, including suitability review, by the on-site supervisor/principal, followed by transmittal of the VA application to the Insurance Agency for an additional review by Insurance Agency principals before the Insurance Agency transmitted the VA application to the issuing insurance company.[43] The WSPs did not, however, contain a similar description of the review process sequence for VA transactions originated by non-OSJ RRs. In practice, that process entailed an initial review, including suitability review, by Insurance Agency principals, after which the Insurance Agency gave the application package to the Regional OSJ Manager for review, but also sent the VA application to the issuing insurance company prior to obtaining a suitability sign-off from the Regional OSJ Manager.

SWS argued that the same review steps occurred regardless of whether a VA application originated in an OSJ branch offices or it came from a non-OSJ RR, with only the order of the review steps differing, and that there was no confusion about the required steps for either process. The evidence adduced at the hearing, however, established that, while the principals performing the reviews understood what steps were required, there was uncertainty regarding the respective roles, responsibilities, and resources of Insurance Agency principals and Regional OSJ Managers in performing suitability reviews of VA transactions from non-OSJ RRs.

For example, Dona Nastasi, a former SWS Regional OSJ Manager, testified that in conducting her suitability reviews of proposed VA transactions, she understood she was to "rely on [the Insurance Agency] for any suitability information that we needed." She "did not have access to the [Ernst & Young] suitability tool that the insurance department had access to ...." If she felt she needed information regarding the existing or proposed VA that was not in the VA application packet she received from the Insurance Agency, she understood that under SWS's procedures, she was required to "rely on [the Insurance Agency principals] to get the information [she needed] ...."[44] In particular, she never directly contacted the RRs she supervised to obtain information to assist her in reviewing the suitability of proposed VA transactions, but rather understood that SWS's "procedure was to rely on the insurance department for our suitability reviews so we could get with them and they would do that contacting for us."[45]

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[41] NASD Rule 3010 was applicable during the Relevant Period. As part of FINRA's rule consolidation program, the relevant provisions of the rule are currently set forth in FINRA Rule 3110.

[42] *See* JX-16, at 3-4, 6-7, 11-12.

[43] JX-16, at 5.

[44] Tr. 37-38.

[45] Tr. 50, 52.

No other Regional OSJ Managers testified at the hearing, but OTR excerpts of KR, who was also an SWS Regional OSJ Manager during the Relevant Period, were received in evidence. In his OTR testimony, KR confirmed that the Regional OSJ Managers did not have access to the Ernst & Young research tool used by the Insurance Agency principals and that if Regional OSJ Managers wanted additional information not included in the VA package when performing a suitability review, they were to obtain it from the Insurance Department, but he also indicated that he did directly contact RRs in order to obtain additional information in at least some cases.[46]

In contrast, Hal Applegate, former National Sales Supervisor for SWS, who supervised the Regional OSJ Managers during the Relevant Period, testified that if a Regional OSJ Manager wanted additional information beyond that contained in the VA package in order to perform a suitability review, "if it pertained to the policy or the mechanics or the riders or whatever having to do with the policy itself, I would ask them to go back to the insurance department ... [but] [i]f it pertained to a question of suitability, client, something like that, they'd go back to the [RR] and ask clarification questions ...."[47] Michael Cogliano, SWS's Chief Compliance Officer, testified that the Regional OSJ Managers "can use whatever they feel they need to conduct their supervisory reviews. They can use whatever is provided in the [VA application package], they can reach out to the insurance department and use them as a resource. They can contact the broker. They can contact the client."[48]

Both Pittman and Franco, the Insurance Agency principals, testified at the hearing. Pittman described herself as the "resource for anything that [the Regional OSJ Managers] wanted, any questions that they might have regarding an insurance product or insurance company or just any questions they might have."[49] She mistakenly believed, however, that during the Relevant Period the Regional OSJ Managers had direct access to the same Ernst & Young reports tool that the Insurance Agency principals used to assist them in reviewing VA application packages, and she believed the Regional OSJ Managers contacted RRs directly if

[46] CX-114. KR resigned from SWS on the day his OTR was scheduled, before he came to the OTR, and he has not been registered with any FINRA member firm since then. KR was not represented by counsel at the OTR, and it appears from his OTR testimony that he was upset about resigning from his job, concerned about Enforcement's investigation, and anxious to distance himself from SWS and its VA review practices. Further, much of his testimony addressed events that occurred after the Relevant Period. SWS's counsel was not present, because it was an OTR, and KR was therefore not subject to cross-examination. Under these circumstances, the Extended Hearing Panel does not give substantial weight to KR's testimony, except insofar as it was consistent with the testimony of witnesses who testified at the hearing regarding SWS's VA review practices during the Relevant Period.

[47] Tr. 198, 200, 234.

[48] Tr. 646.

[49] Tr. 278.

they had any questions about a VA application.[50] Like Pittman, Franco mistakenly believed that the Regional OSJ Managers had direct access to the Ernst & Young reports.[51]

There is no need to attempt to definitively resolve the different understandings of the VA suitability review process expressed by the witnesses. None of the witnesses' testimony was inherently incredible, and all appeared to be attempting to accurately recount the process during the Relevant Period, based on their current recollections. The Extended Hearing Panel finds that the conflicting testimony reflected a failure of SWS to provide clear guidance in its WSPs to assist the Regional OSJ Managers and the Insurance Agency principals in coordinating their suitability reviews of VA transactions, not disingenuousness, confusion, or poor memories on the part of the witnesses.

In addition, SWS's WSPs failed to address the timing of the submission of VA applications received from non-OSJ RRs to the issuing insurance companies. This omission was significant. VA applications from OSJ branch offices were reviewed by the branch manager/principal before they were sent to the Insurance Agency, so once they were reviewed by an Insurance Agency principal, the suitability review was complete and it was appropriate to send the applications to the issuing insurance company. In contrast, for VA transactions originated by non-OSJ RRs, the final suitability review conducted by the Regional OSJ Managers occurred after the Insurance Agency principals' review. In the absence of any WSPs directly addressing the review sequence for VA transactions originated by non-OSJ RRs, the Insurance Agency adopted the practice of sending the applications to the issuing insurance company as soon as the Insurance Agency principal's review was completed, without waiting for the Regional OSJ Manager's sign-off. As explained below, sending the VA applications to the insurers before they were reviewed by the Regional OSJ Managers violated Rule 2330(c). If the WSPs had included provisions addressing the sequence of review of VA applications from non-OSJ RRs, those violations could have been avoided.

Accordingly, the Extended Hearing Panel concludes that SWS's WSPs failed to set forth supervisory procedures reasonably designed to achieve compliance with the standards set forth in Rule 2330, and SWS thereby violated FINRA Rules 2330(d) and 2010, as well as NASD Rule 3010, as alleged in the first cause of the Complaint.[52]

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[50] Tr. 301, 303.

[51] Tr. 506.

[52] Rule 2010 provides: "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade." It is well settled that a violation of another FINRA rule is a violation of FINRA Rule 2010. *See William J. Murphy*, Exchange Act Release No. 69923, 2013 SEC LEXIS 1933, at *26 n.29 (July 2, 2013), *aff'd sub nom.*, *Birkelbach v. SEC*, 751 F.3d 472 (11th Cir. 2014) (noting that the violation of another Commission or FINRA rule or regulation constitutes a violation of FINRA Rule 2010).

C. Suitability Review

Rule 2330(c) provides that, "[p]rior to transmitting a customer's application for a deferred variable annuity 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 variable annuity," and further provides that "[a] registered principal shall approve the recommended transaction only if he or she has determined that there is a reasonable basis to believe that the transaction would be suitable [for the customer]."

Enforcement alleged that SWS violated these provisions of Rule 2330, as well as the general supervisory requirements in NASD Rule 3010, in 13 specific VA transactions because the reviewing Regional OSJ Manager lacked a reasonable basis to conclude that the transactions were suitable for the customers. Although much of the testimony elicited by Enforcement at the hearing related to suitability review of VA transactions generally, the parties stipulated prior to the hearing that "the specific VA transactions on which Enforcement bases its claims and for which it seeks sanctions are the 13 'questionable' transactions ... that are identified in Enforcement's Bill of Particulars."[53] Accordingly, the Extended Hearing Panel limits its assessment of the adequacy of SWS's suitability review to those transactions.

Rule 2330(b) describes the information to be considered in determining whether a VA investment is suitable for a customer:

> (1) No member or person associated with a member shall recommend to any customer the purchase or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to believe
>
> (A) that the transaction is suitable in accordance with Rule 2111[[54]] and, in particular, that there is a reasonable basis to believe that
>
> (i) the customer has been informed, in general terms, of various features of deferred variable annuities, such as the potential surrender period and surrender charge; potential tax penalty if customers sell or redeem deferred variable annuities before reaching the age of 59½; mortality and expense fees; investment advisory fees; potential charges for and features of riders; the insurance and investment components of deferred variable annuities; and market risk;
>
> (ii) the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit; and

[53] Stip. ¶ 13.

[54] Enforcement did not allege any violation of Rule 2111 in connection with the suitability reviews of the 13 VA transactions at issue.

(iii) the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity, and riders and similar product enhancements, if any, are suitable (and, in the case of an exchange, the transaction as a whole also is suitable) for the particular customer based on the information required by paragraph (b)(2) of this Rule; and

(B) in the case of an exchange of a deferred variable annuity, the exchange also is consistent with the suitability determination required by paragraph (b)(1)(A) of this Rule, taking into consideration whether

(i) the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living, or other contractual benefits), or be subject to increased fees or charges (such as mortality and expense fees, investment advisory fees, or charges for riders and similar product enhancements);

(ii) the customer would benefit from product enhancements and improvements; and

(iii) the customer has had another deferred variable annuity exchange within the preceding 36 months.

The determinations required by this paragraph shall be documented and signed by the associated person recommending the transaction.

(2) Prior to recommending the purchase or exchange of a deferred variable annuity, a member or person associated with a member shall make reasonable efforts to obtain, at a minimum, information concerning the customer's age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, investment time horizon, existing assets (including investment and life insurance holdings), liquidity needs, liquid net worth, risk tolerance, tax status, and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers.

For each of the 13 VA transactions cited by Enforcement, the VA application package, including SWS's completed compliance documents and the additional materials included in the package, addressed each of the topics set forth in Rule 2330(b). Nevertheless, Enforcement contended that the Regional OSJ Managers' suitability reviews of the 13 transactions were deficient because "reasonable review requires: (1) independently reviewing transactions (instead of relying solely on the representations of representatives selling the securities or other principals

reviewing the transactions); (2) responding to red flags by contacting customers, reviewing prospectuses, contacting issuing insurance companies or other appropriate, independent analysis; and (3) reviewing the accounts for concentration levels in specific securities."[55]

The evidence does not support Enforcement's contention that the Regional OSJ Managers did not independently review the suitability of the 13 transactions, or that they relied solely on the representations of the RRs or the Insurance Agency principals. As described above, each VA package included substantial information about the proposed transaction that addressed each of the factors set forth in Rule 2330(b). In particular, in each case the customer had signed or initialed clear, concise, and detailed disclosures about the costs and benefits of the proposed transaction and the reasons why the transaction was in the customer's interest.

Ten of the VA packages contain a Branch Manager/OSJ Suitability Review Form on which the Regional OSJ Manager verified that he or she had reviewed the VA application package, considered the suitability factors set forth in Rule 2330(b), and approved the transaction based on that consideration. While the remaining three packages, as included in Enforcement's exhibits, do not contain such a form, there is no basis for the Extended Hearing Panel to infer that no such forms were completed for those transactions.[56] In any event, Enforcement offered no evidence that the Regional VA Managers did not, in fact, independently review the information contained in the application packages for any of the 13 VA transactions at issue, or that they did not consider the factors set forth in Rule 2330(b), or that they did not independently conclude, on the basis of their review, that the transactions were suitable for the customers. Further, as explained below, the evidence did not substantiate Enforcement's contention that

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[55] Department of Enforcement's Pre-Hearing Brief at 18 (footnotes omitted). In support of these supposed requirements, Enforcement cited *Dep't of Enforcement v. Brookstone Sec., Inc.*, No. 2007011413501, 2012 FINRA Discip. LEXIS 52, at *101 (OHO May 31, 2012), *aff'd*, 2015 FINRA Discip. LEXIS 3 (NAC Apr. 16, 2015). That case, however, is plainly distinguishable from this proceeding because it involved a compliance supervisor's failure to evaluate the suitability of high risk collateral mortgage obligation ("CMO") investments in discretionary accounts of unsophisticated customers of the firm in spite of various red flags, including "the high number of CMO accounts that were owned by customers who were retired and/or over the age of 65, or had what was no greater than a moderate risk tolerance, yet were investing in high-risk securities and/or trading on margin." *Id.*

[56] *See* fn. 21, *supra.*

there were red flags in the 13 VA applications to which the Regional OSJ Managers failed properly to respond. Finally, the Extended Hearing Panel notes that Rule 2330(b)'s detailed description of the matters that must be considered in determining whether a VA transaction is suitable does not include "reviewing the accounts for concentration levels in specific securities."[57]

Ten of the VA transactions cited by Enforcement were submitted by RR LN. Each of the transactions included a VA application package with SWS's proprietary compliance forms and supporting materials, as described above. Each of the VA application packages was reviewed and approved by one of the Insurance Agency principals before being transmitted to a Regional OSJ Manager for final suitability review. Eight of the LN VA applications were reviewed by Regional OSJ Manager Nastasi, LN's manager, while two were reviewed by Regional OSJ Manager KR when Nastasi was away from the office.[58]

Enforcement questioned both Nastasi and the Insurance Agency principal who had reviewed the VA application about the bases for their conclusions that the eight LN proposed VA transactions approved by Nastasi were suitable for the customers, and questioned the reviewing Insurance Agency principal regarding the suitability of the remaining two LN transactions.[59] All of the transactions had been reviewed more than four years prior to the hearing, and it was apparent that Nastasi, who is no longer employed by SWS, had not had an opportunity to review the VA application packages prior to the hearing.[60] Nevertheless, by referring to the materials contained in the VA packages, Nastasi was able to explain why she

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[57] Rule 2330(c) states that "[t]he determinations required by this paragraph shall be documented and signed by the registered principal who reviewed and then approved or rejected the transaction." In its closing argument at the hearing, Enforcement urged that the Regional OSJ Managers failed to properly document the grounds on which they concluded that the 13 transactions were suitable by setting forth their reasoning in narrative form. Rule 9212(a)(1), however, provides: "The complaint shall specify in reasonable detail the conduct alleged to constitute the violative activity and the rule, regulation, or statutory provision the Respondent is alleged to be violating or to have violated." In this case, the Complaint did not allege that SWS violated the documentation requirement of Rule 2330(c). Indeed, Enforcement did not articulate any such theory of liability in its pre-hearing briefing. Thus, SWS did not have reasonable notice of the charge or a reasonable opportunity to offer evidence or argument to address it. Accordingly, the Extended Hearing Panel finds it unnecessary to determine whether the documentation in the 13 VA application packages at issue was sufficient to satisfy the requirements of Rule 2330(c). The Extended Hearing Panel also notes that Rule 2330 does not state that the reviewing principal must include a narrative explanation of the reasons for concluding that a VA application is suitable for the customer, and that each of the VA application packages included substantial documentation supporting the suitability of the transaction, including, for at least 10 of the 13 transactions at issue, a Branch Manager/OSJ Suitability section of the Variable Annuity Compliance Form/Approval form completed and signed by the Regional OSJ Manager.

[58] CX-29; CX-30; CX-31; CX-55; CX-61; CX-62; CX-64; CX-65 (reviewed by Nastasi); CX-52; CX-63 (reviewed by KR).

[59] KR did not testify at the hearing and during his OTR Enforcement did not question him about his approvals of the two LN transactions he reviewed

[60] Tr. 179.

reasonably believed that each proposed transaction was in the best interests of the customer.[61] In contrast to Nastasi, the two Insurance Agency principals, who are still employed at the Insurance Agency and continue to review the suitability of VA transactions, clearly had reviewed the VA application packages prior to the hearing and were able to more clearly articulate why, based on the information included in the VA package, they reasonably concluded that each VA transaction was suitable for the customer.[62]

In questioning Nastasi and the Insurance Agency principals regarding LN's proposed VA transactions, Enforcement pointed out that there were some countervailing factors weighing against the proposed transaction. For example, for exchange transactions (which accounted for all but one of the LN transactions at issue), the customer may have incurred a surrender charge for the VA being exchanged, or a longer surrender period for the new VA, or a reduced current market value. And typically the total annual charge for the new VA was greater than the total annual exchange for the VA being exchanged.

It was not difficult for Enforcement to identify these countervailing factors because they were clearly reflected in the one-page Annuity Exchange and Replacement Form that had been completed by the RR and signed by the customer for every exchange. As noted above, each such form included a side-by-side comparison of the key provisions of the customer's existing VA and the proposed new VA, allowing both the customer and the reviewers to quickly identify both the advantages and the disadvantages of the proposed exchange. In each case, the reviewing Insurance Agency principal and Nastasi were able to articulate a reasonable basis for their conclusion that, notwithstanding the countervailing factors, they concluded that the new VA was in the customer's best interest, based on the information included in the VA application package.[63]

Enforcement also pointed out that in the portion of the Annuity Exchange and Replacement Forms requiring the RR to explain why the transaction was in the customer's best interest, LN consistently indicated that the customer did not want to annuitize the existing VA, which the customer would have had to do to obtain a living benefit payout. Enforcement contended that this was a red flag that should have caused the reviewer to question the suitability of the transaction and to seek additional information from the insurance companies or directly from the customers.

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[61] Tr. 56-110, 157-75.

[62] Tr. 400-33, 472-79, 515-39, 571-77.

[63] The only LN transaction at issue that was not an exchange involved the purchase of a new VA with funds obtained by liquidating mutual funds. CX-29. As with the exchanges, Nastasi and the Insurance Agency principal who had reviewed the transaction were able to articulate a reasonable basis for believing it was suitable for the customer based on the information included in the VA application package, including the one-page Annuity Purchase Form completed by LN and signed by the customer. Tr. 70-73, 160-62, 575-76.

The Extended Hearing Panel rejects Enforcement's contention. In fact, the desire to avoid annuitization was a reasonable explanation for a customer's desire to exchange an existing VA. Annuitization of a VA means converting it from an investment, over which the customer retains ultimate ownership and authority, into an annuity whereby the customer's funds are transferred to the insurance company in exchange for the insurance company's agreement to provide an income stream to the customer over a defined period.[64] Nastasi and the Insurance Agency principals explained that in many cases, VA customers, not unreasonably, are reluctant to turn over ownership of their VA investments to the insurance companies—*i.e.*, they do not want to annuitize them. They further explained that during the Relevant Period, insurance companies had begun offering VA products that could be used to provide an income stream to the customer without having to annuitize the VA. Thus, they did not view it as suspicious that many of the Annuity Exchange and Replacement Forms include a statement that the customer did not want to annuitize the existing VA.[65] Under the circumstances presented, the Extended Hearing Panel finds that the mere fact that many VA applications indicated that the customers did not want to annuitize their existing VAs was not a red flag suggesting that the explanations for the exchange were unreliable or that it was necessary for the reviewing principal to contact the customer directly.

The remaining three proposed VA transactions cited by Enforcement were submitted by RR NV.[66] Each of the three transactions involved the sale of an existing MassMutual Life Insurance Company VA with the proceeds of the sale contributed to a Jackson National Life Insurance Company VA that the customer already owned. In each case, the reason for the transaction given by NV on the SWS's compliance documents in the VA application package was that a living benefit rider could not be added to the Mass Mutual VA. According to NV's explanation, when the customer purchased the VA, MassMutual indicated that a living benefit rider could be obtained after the third policy year, but since the purchase MassMutual had withdrawn that offer and it would not be possible to add a living benefit rider to the MassMutual VA. The explanation further stated that a living benefit rider could be added to the customer's existing Jackson National VA at age 45. In each case, both NV and the customer initialed a portion of the form in bold type stating: "We have confirmed with the existing carrier that the additional benefits are not able to be added to the current contract." Two of these transactions were reviewed at the Insurance Agency by Pittman and one by Franco. KR, who was NV's Regional OSJ Manager, acknowledged during his OTR that he reviewed and approved all three NV transactions.[67] No documentation of his review, however, was included in the VA application packages submitted by Enforcement.[68]

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[64] Tr. 190-91.

[65] Tr. 64, 79-80, 152-54, 190, 401-02, 404, 525-27.

[66] CX-36; CX-59; and CX-60.

[67] CX-114.

[68] *See* fn. 21, *supra*.

Much of Enforcement's concern about these transactions related to NV's explanation of the MassMutual VA purchases. Enforcement did not dispute that a living benefit rider could not have been added to the customers' MassMutual VAs at the time they sold them, but Enforcement contended that NV's assertion that MassMutual had indicated such a rider could later be added when the customers purchased the VAs was a red flag. Enforcement contended that to conduct a reasonable suitability review, it would have been essential for the reviewing principal to confirm NV's assertion by contacting MassMutual or the customers. It is undisputed that in their suitability reviews, neither the Insurance Agency principals nor KR contacted either MassMutual or the customers to verify the circumstances of the MassMutual VA purchases.[69]

The Extended Hearing Panel does not agree with Enforcement's contention that NV's assertion about the MassMutual VAs was a red flag or that it was necessary to confirm its accuracy in order to perform a reasonable suitability review of the proposed VA transactions. First, Enforcement offered no evidence that the reviewers had any reason to question NV's veracity based on past experience.[70] Second, Enforcement offered no evidence that NV's statement that an insurer had decided to withdraw a potential rider before it could be added to existing VAs was inherently suspicious.[71] Third, the relevant suitability issue related to the sale of the MassMutual VAs and investment of the proceeds in the customers' existing Jackson National VAs, not the circumstances under which the MassMutual VAs were purchased. Regardless of whether at the time of purchase MassMutual represented that it would be possible to add a living benefit rider to the VAs in the future, it is undisputed that at the time of the transactions at issue, it was not possible to add such a rider to the MassMutual VAs.[72] The issue for the reviewing principals, therefore, was whether, in that circumstance, the sale of the

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[69] Tr. 380-381, 541; CX-114, at 26. Enforcement did not allege or attempt to prove that NV's assertion about the understanding when the MassMutual VAs were purchased was false. Although Enforcement pointed out that it was never possible to add a living benefit rider to the particular MassMutual VA that the customers purchased, NV explained during his OTR that the understanding was that the customers would be able to exchange their MassMutual VAs for different MassMutual VA products that did offer a living benefit rider. The evidence showed that MassMutual froze the availability of living benefit riders on those products prior to the transactions at issue. CX-104, at 10-12, 15-16; JX-25.

[70] *See* Tr. 461-62 ("Q: How long had you worked with [NV] before these MassMutual exchanges came up? A: I've worked with him since 2006, when I started. Q: Have you had any problems with the reliability of information that he's provided you in the past? A: No. Q: During this conversation, did he give you any indication for you to think that he was not being truthful with you about the situation with MassMutual? A: No.").

[71] Pittman credibly testified: "[NV] told me that the clients had MassMutual products and they would no longer be able to add the living benefits to them, and I believed that. I believed that. There were several changes in the industry that many companies were doing, so I had no reason think he was lying about it." Tr. 379. *See also* Tr. 539 (Franco, explaining that she understood that insurers had the right to withdraw offers to allow customers to add riders to their VAs).

[72] Tr. 390, 462.

MassMutual VAs and investment of the proceeds in the customers' Jackson National VAs appeared suitable for the customers.[73]

Enforcement also argued that there was not a sufficient basis for a reasonable conclusion that the three NV transactions were suitable because the customers were not eligible to add a living benefit rider to their existing Jackson National VAs at the time of the transactions. It was undisputed that the customers would not have an opportunity to add a living benefit rider to their Jackson National VAs until they were 45 years old. One customer was 39, one was 37, and one was 31 years old.[74] Enforcement pointed out that as a result of the transactions, the customers incurred surrender fees for the sale of the MassMutual VAs and higher costs with the Jackson National VAs.

Based on the information contained in the VA application packages, the Insurance Agency principals, who testified at the hearing, were able to articulate a reasonable basis for their conclusions that the three NV VA transactions were suitable for the customers, notwithstanding the delayed availability of the living benefit rider, the surrender fees, and the additional costs. They pointed out that the factors that Enforcement cites (the preclusion on adding the living benefit rider to the Jackson National VA until age 45, the surrender fees, and the additional costs) were clearly disclosed to each customer on the one-page Annuity Exchange and Replacement Form included in each VA application package, which was signed and dated by the customer. Each of the customers already owned the Jackson National VA to which the proceeds of the MassMutual sale would be added, so they were able to consolidate their VA investments through the transaction, and the amounts of the surrender fees and additional costs were modest. For the 31-year-old customer, which Enforcement cites as the most obvious red

[73] In addition to the three transactions that Enforcement contends the reviewing principals lacked a reasonable basis to believe were suitable, there were a number of other similar transactions in which NV recommended the sale of the customer's existing MassMutual VA, for the same reason, and investment of the proceeds in the customer's existing Jackson National VA. It appears that in those transactions the customers were over 45 and could thus obtain the desired living benefit rider immediately. Nevertheless, Enforcement argued that the fact that NV offered the same explanation for the sale of the MassMutual VAs in so many transactions should have raised a red flag for the reviewing principals, requiring them to contact MassMutual or the customers directly. Tr. 738.

As NV explained in his OTR, the customers who had purchased MassMutual VAs were University of Oklahoma faculty members and their VAs were investments in their 403(b) university retirement accounts, which offered a limited number of potential investments. It was, therefore, not suspicious that they had all invested in MassMutual VAs; that they all had the same understanding that they would be able to add living benefit riders to those VAs; or that, when they learned that would not be possible, they elected to sell the MassMutual VAs and invest the funds in their existing Jackson National VAs where they could obtain a living benefit rider. Indeed, NV explained during his OTR that after he explained the circumstances, about half his University of Oklahoma customers who were invested in MassMutual VAs elected to sell them and invest the proceeds in their existing Jackson National VAs. CX-104, at 8-10, 19-21.

[74] CX-36, at 1; CX-59, at 1; CX-60, at 1.

flag, the surrender fee was $199 and the additional costs would amount to a total of $29.31 over the 13-year period before he turned 45.[75]

KR, who made the final suitability determination for the three NV transactions did not testify at the hearing. In his OTR, KR testified that he had concerns about the circumstances of the original purchases of the MassMutual VAs, but they were alleviated after he spoke to NV and Pittman.[76] As explained above, those circumstances were not relevant to an assessment of the suitability of the sale of the MassMutual VAs and investment of the proceeds in the customers' Jackson National VAs. Enforcement did not ask KR to review the VA application packages during his OTR and did not question him about his consideration of the limitation on adding a living benefit rider to the Jackson National VAs or the surrender fees and additional costs when he performed his suitability reviews of the transactions.

Accordingly, the Extended Hearing Panel concludes that Enforcement did not prove by a preponderance of the evidence that SWS violated FINRA Rules 2330(c) and 2010, or NASD Rule 3010, as alleged in the second cause of the Complaint.

D. Transmittal of VA Applications Prior to Suitability Review

Rule 2330(c) provides, in part:

> Prior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing, but no later than seven business days after an office of supervisory jurisdiction of the member receives a complete and correct application package, a registered principal shall review and determine whether he or she approves of the recommended purchase or exchange of the deferred variable annuity.

In the third cause of the Complaint, Enforcement alleged that during the Relevant Period, SWS transmitted 38 specifically identified VA applications to issuing insurance companies for processing prior to the required suitability review by a registered principal. Undisputed evidence established that in each of the instances cited by Enforcement, the Insurance Agency transmitted the VA application to the insurance company after the Insurance Agency principal had completed her review of the application, including her (preliminary) suitability review, but prior to the completion of the (final) suitability review performed by the Regional OSJ manager. Indeed, this was the Insurance Agency's routine practice during the Relevant Period.

SWS argued that the Rule required only that there be a suitability review by "a registered principal" before the application was transmitted, and that the Insurance Agency principals met this description, even though they were not registered with SWS. The Extended Hearing Panel

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[75] Tr. 553-54.

[76] CX-114, at 24-26.

rejects that contention. As explained in NASD Notice to Members 05-48, "a member may never contract its supervisory and compliance activities away from its direct control."[77] Even though both the Insurance Agency and Southwest Securities were affiliated with SWS, without the Insurance Agency principals being registered with SWS, it lacked direct control over their activities. Even Applegate, the former National Sales Supervisor for SWS who supervised the Regional OSJ Managers during the Relevant Period, acknowledged that the required suitability review could not be performed by a principal registered with another firm, such as the Insurance Agency principals.[78] Moreover, as explained above, all of the witnesses agreed that the suitability review by the Insurance Agency principals was intended to be merely preliminary, and that the final, definitive suitability review was performed by the Regional OSJ Managers. Rule 2330(c) does not permit a VA application to be forwarded to the issuing insurance company based on a preliminary suitability assessment by a principal not registered with the firm.

SWS also argued that forwarding the VA applications to the issuing insurance company prior to the completion of the suitability review was an insignificant "timing issue" because if the reviewing Regional OSJ Manager concluded that a VA application was not suitable after it was transmitted to the insurance company, SWS "would reach out to the [insurance] carrier, whoever that carrier may be, and then claw back the contract."[79] The Extended Hearing Panel also rejects that argument. The Rule is crystal clear: the suitability review must take place *before* the application is sent to the insurance company. Further, the "timing issue" is not insignificant. Even assuming that an application for a new VA could be canceled if the Regional OSJ Manager determined the transaction was unsuitable, in the case of an exchange, it would not have been possible to unwind the cancelation of the customer's existing VA if the cancellation occurred before the Regional OSJ Manager determined that the exchange was unsuitable. Thus, the practice of submitting VA applications to issuing insurance companies prior to the completion of the suitability review could have caused substantial customer injury.[80]

Accordingly, the Extended Hearing Panel concludes that SWS violated Rule 2330(c) on 38 occasions during the Relevant Period by submitting VA applications to the issuing insurance companies prior to the completion of the required suitability review, and thereby also violated Rule 2010, as alleged in the third cause of the Complaint.

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[77] NASD Notice to Members 05-48 (July 2005), http://www.finra.org/industry/notices/05-48.

[78] Tr. 219.

[79] Tr. 631.

[80] Tr. 774-75. In fact, however, the Regional OSJ Managers did not disapprove any VA transactions as unsuitable during the Relevant Period. Tr. 454-55.

E. Surveillance Procedures and Corrective Measures

During the Relevant Period, Rule 2330(d) provided, in part:

> The member also must (1) implement surveillance procedures to determine if any of the member's associated persons have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of this Rule, other applicable FINRA rules, or the federal securities laws ("inappropriate exchanges") and (2) 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.

In the fourth cause of the Complaint, Enforcement alleged that SWS violated these provisions during the Relevant Period because it did not have surveillance procedures to monitor its RRs' rates of effecting VA exchanges. Further, Enforcement alleged that SWS did not have in place any policies and procedures to implement corrective measures to address inappropriate exchanges or the conduct of any RRs who engaged in inappropriate exchanges.

As explained above, SWS did not have any systematic procedures for monitoring VA exchange rates. But SWS defends its lack of procedures by pointing out that Rule 2330 does not require any specific type of surveillance procedures, and that FINRA advised member firms that they were not required to employ an automated system to monitor exchange rates. Rather, FINRA advised that: "The rule allows a firm to determine how to screen for and supervise such activity. Thus, a firm could perform this type of review on a periodic basis via exception reporting rather than as part of the principal review of each exchange transaction."[81]

SWS's WSPs, however, did not clearly identify who was to monitor exchange rates or how they were to identify excessive exchanges; rather, they simply left it to "The Manager of Southwest Insurance Agency" and the "Branch Manager/OSJ Manager" to, in effect, "keep an eye out" for suspicious exchanges or high exchange rates, without providing *any* guidance to assist reviewers in evaluating whether exchanges rates were excessive.[82] Furthermore, insofar as the WSPs attempted to task Insurance Agency principals who were not registered with SWS with responsibility for determining whether exchange rates were excessive, they represented an improper attempt to outsource SWS's supervisory and compliance obligations.

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[81] FINRA Regulatory Notice 07-53 (Nov. 2007), http://www.finra.org/industry/notices/07-53.

[82] The Extended Hearing Panel rejects, however, Enforcement's contention that SWS was required to define a specific rate of exchange as "excessive" in its WSPs. No such requirement is stated in the Rule, nor can such a requirement be fairly implied. Indeed, simply focusing on the percentage of exchanges could be misleading, as it might suggest that an RR who recommended one exchange out of two total VA transactions (50%) raised greater concern than an RR who recommended 40 exchanges out of 100 total VA transactions (40%).

SWS also points out that the Insurance Agency maintained a database of VA transactions and that during the latter part of the Relevant Period, the database included information as to whether each VA transaction was an exchange. Utilizing this database, it would have been possible to monitor the exchange rates of RRs, as SWS began doing after the Relevant Period.

SWS's WSPs, however, merely provided "Insurance Database reviewed to identify patterns including excessive exchanges ... [d]aily, or as required." The Regional OSJ Managers, who were responsible for supervising the non-OSJ RRs, could not have followed this direction because they did not have access to the database. The Insurance Agency principals who reviewed VA transactions did have access to the database, but they testified that they did not use it to monitor VA exchange rates on a "daily, or as required" basis during the Relevant Period. Rather, they consulted it only about once a year, if in the course of their review of VA applications they happened to notice a possible exchange rate issue. And, in any event, the Insurance Agency principals were not registered with SWS and therefore could not be delegated responsibility for fulfilling SWS's supervisory and compliance obligations under Rule 2330.

Accordingly, the Extended Hearing Panel concludes that SWS violated Rule 2330(d) during the Relevant Period, as alleged in the fourth cause of the Complaint, by failing to implement surveillance procedures to determine if any of its RRs had rates of effecting VA exchanges that raised for review whether such rates of exchanges evidenced inappropriate exchanges. SWS thereby also violated Rule 2010.

On the other hand, as explained above, SWS included provisions in its WSPs that established corrective measures for any type of improper transaction. Those provisions were fully adequate to address any inappropriate exchanges. Similarly, the WSPs included general provisions for addressing inappropriate conduct by RRs, and those provisions were adequate to address any such conduct that involved inappropriate VA exchanges. Therefore, the Extended Hearing Panel concludes that Enforcement did not prove by a preponderance of the evidence that SWS violated Rule 2330(d) by failing to have policies and procedures to implement corrective measures to address inappropriate exchanges or the conduct of any RRs who engaged in inappropriate exchanges, as alleged in the fourth cause of the Complaint.

F. Training

During the Relevant Period, Rule 2330(e) provided:

> Members shall 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 this Rule and that they understand the material features of deferred variable annuities, including those described in paragraph (b)(1)(A)(i) of this Rule.

Before the effective date of Rule 2330, NASD Rule 2821(e) contained the same requirement. In the fifth cause of the Complaint, Enforcement alleged that SWS violated these provisions because it failed to implement adequate training procedures to ensure that principals who reviewed VA transactions for suitability had adequate knowledge to monitor for compliance with FINRA rules.

As described above, SWS provided a variety of formal and informal training for both Insurance Agency principals and the Regional OSJ Managers, including a mandatory course on the requirements of NASD Rule 2821 and FINRA Rule 2330. Moreover, the principals who reviewed VA transactions were not neophytes. The Insurance Agency principals were devoted full time to reviewing VA and other insurance transactions submitted by RRs, and SWS had a practice of hiring experienced principals to serve as Regional OSJ Supervisors. For example, the two Regional OSJ Supervisors who performed the final suitability reviews on the transactions cited by Enforcement discussed above both had come from another FINRA member firm where they had been responsible for reviewing the suitability of VA transactions. The former Regional OSJ Supervisor who testified at the hearing was very knowledgeable regarding VA transactions and the requirements of FINRA rules for review of those transactions. Similarly, the two Insurance Agency principals, both of whom testified at the hearing, were also very knowledgeable regarding VAs and FINRA requirements. Finally, SWS's WSPs described in detail the factors that principals who reviewed VA transactions should consider in performing suitability reviews.

The Hearing Panel concludes, therefore, that Enforcement did not prove by a preponderance of the evidence that SWS violated FINRA Rules 2330(e) and 2010, and NASD Rule 2821(e), by failing to implement adequate training procedures to ensure that principals who reviewed VA transactions for suitability had adequate knowledge to monitor for compliance with FINRA rules, as alleged in the fifth cause of the Complaint.

IV. Sanctions

For the reasons set forth above, the Extended Hearing Panel has determined that SWS violated FINRA Rule 2330 in certain respects, and thereby also violated FINRA Rule 2010 and NASD Rule 3010. FINRA's Sanction Guidelines do not specifically address violations of Rule 2330, but the Extended Hearing Panel concludes that the guidelines for deficient written supervisory procedures and those for failure to supervise are applicable in determining the appropriate sanctions for the violations found in this proceeding.[83] Further, the Extended Hearing Panel concludes that because the violations all related to SWS's compliance with the

[83] FINRA Sanction Guidelines at 103, 104 (2015), http://www.finra.org/industry/sanction-guidelines.

supervisory requirements imposed in a single rule relating to a single product, it is appropriate to impose a unitary sanction for the violations.[84]

The guidelines for deficient written supervisory procedures recommend a fine of $1,000 to $37,000, while those for failure to supervise recommend a fine of $5,000 to $73,000. In egregious cases, both guidelines suggest consideration of additional non-monetary sanctions, but the Extended Hearing Panel does not find SWS's violations to be sufficiently egregious to call for such sanctions.[85]

The guidelines for deficient supervisory procedures direct the Extended Hearing Panel to consider whether the deficiencies allowed violative conduct to occur or to escape detection.[86] In this case Enforcement did not prove its allegations that SWS's suitability review was deficient, but did prove that SWS, through the Insurance Agency, transmitted VA applications to insurance companies before the required suitability review was completed. The deficiencies in SWS's WSPs contributed to this violation. The guidelines for deficient supervisory procedures also direct the Extended Hearing Panel to consider whether the deficiencies made it difficult to determine the individual or individuals responsible for specific areas of supervision or compliance. In this case, the deficiencies in SWS's WSPs made it difficult to determine the responsibilities of the Regional OSJ Managers, as compared to the responsibilities of the Insurance Agency principals, in monitoring for excessive or improper exchanges.

The guidelines for failure to supervise direct the Extended Hearing Panel to consider whether SWS ignored "red flag" warnings, and the "[n]ature, extent, size and character of the underlying misconduct."[87] The Extended Hearing Panel did not find that SWS ignored red flags during the Relevant Period. On the other hand, the evidence established that 38 VA applications were transmitted to the issuing insurance companies prior to the completion of the suitability review process and that the premature transmission of VA applications was a regular practice during the Review Period. Enforcement, however, offered no evidence of actual customer injury from this practice.

The Sanction Guidelines also list factors to be considered in setting sanctions for all types of violations.[88] The Extended Hearing Panel finds the following factors relevant to this proceeding: SWS has a prior disciplinary history, which includes prior violations involving deficient supervision and WSPs;[89] the violations continued over an extended period of time; and

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[84] *Cf. Dep't of Enforcement v. Brookstone Sec., Inc.*, No. 2007011413501, 2015 FINRA Discip. LEXIS 3, at *143 (NAC Apr. 16, 2015) (imposing a unitary sanction for supervision violations).

[85] Sanction Guidelines at 103, 104.

[86] *Id.* at 104.

[87] *Id.* at 103.

[88] *Id.* at 6-7.

[89] CX-1.

the violations were attributable to negligence. On the other hand, the Extended Hearing Panel notes that: (1) there is no evidence of injury to any customers or to the investing public generally; (2) there is no evidence that SWS attempted to interfere with Enforcement's investigation; and (3) there is no evidence of regulatory criticism of SWS's practices prior to the examination that led to this proceedings, any of which factors would have been significantly aggravating in determining the appropriate sanctions.

Finally, the Extended Hearing Panel finds that although there were significant deficiencies in SWS's compliance with Rule 2330, there were also aspects of SWS's oversight of VA transactions that were commendable. SWS's two-step principal suitability review, if conducted with clear guidelines, can provide additional protection for customers. In addition, the Extended Hearing Panel was impressed by the compliance forms used by SWS, which captured the key factors regarding proposed VA transactions in a format that made it easy for customers to understand and compare, and for principals to review, and by the knowledge and professionalism of the reviewing principals who testified at the hearing.

Taken together, these factors suggest that significant monetary sanctions are appropriate to impress upon SWS the importance of ensuring that its oversight of VA transactions fully complies with Rule 2330, and to deter SWS and other member firms from future violations. The Extended Hearing Panel concludes that a fine of $50,000 will be sufficient under the circumstances to accomplish FINRA's remedial goals.[90]

V. Order

For violating FINRA Rules 2330(c) and (d) and Rule 2010, and NASD Rule 3010, as set forth above, Respondent SWS Financial Services, Inc. is fined $50,000. In addition, SWS is ordered to pay hearing costs in the amount of $7,476.32, which includes an administrative fee of $750 and the cost of the hearing transcript. The remaining charges in the Complaint are dismissed.

The fine and costs shall be due and payable on a date set by FINRA, but not earlier than 30 days after this decision becomes FINRA's final disciplinary action in this proceeding.

David M. FitzGerald
Hearing Officer
For the Extended Hearing Panel

[90] The Extended Hearing Panel considered all of the arguments of the parties. Arguments not specifically discussed herein are rejected or sustained to the extent that they are inconsistent or in accord with this Decision.

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