

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER, AND CONSENT
NO. 2017052173001**

TO: Department of Enforcement
Financial Industry Regulatory Authority (FINRA)

RE: Farmers Financial Solutions, LLC (Respondent)
Member Firm
CRD No. 103863

Pursuant to FINRA Rule 9216, Respondent Farmers Financial Solutions, LLC submits this Letter of Acceptance, Waiver, and Consent (AWC) for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against Respondent alleging violations based on the same factual findings described in this AWC.

I.

ACCEPTANCE AND CONSENT

- A. Respondent hereby accepts and consents, without admitting or denying the findings and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

BACKGROUND

Farmers Financial Solutions, LLC is a registered broker-dealer and has been a FINRA member since August 2000. The firm has its headquarters in Westlake Village, California. The firm is a broker-dealer that sells variable universal life insurance contracts (VULs), mutual funds, 529 Plans, and annuities. Farmers Financial has approximately 4,300 registered representatives and approximately 3,800 branch offices. Respondent does not have any relevant disciplinary history.

OVERVIEW

From at least June 2016 through December 2018, Farmers Financial failed to establish and maintain a reasonably designed supervisory system to achieve compliance with applicable securities laws and regulations with respect to its VUL business. As a result of the foregoing, Farmers Financial violated FINRA Rules 3110(a) and 2010.

From at least June 2016 to November 2017, Farmers Financial failed to establish and maintain a reasonably designed supervisory system to achieve compliance with applicable securities laws and regulations with respect to its mutual fund business. As a result of the foregoing, Farmers Financial violated FINRA Rules 3110(a) and 2010.

FACTS AND VIOLATIVE CONDUCT

This matter originated from the 2017 and 2019 cycle examinations of Farmers Financial.

FINRA Rule 3110(a) requires that FINRA members “establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.” The firm needs to supervise for compliance with FINRA Rule 2111, which requires that a member “have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer,” including “a reasonable basis to believe that the customer has the financial ability to meet such commitment.”¹ A violation of FINRA Rule 3110 constitutes a violation of FINRA Rule 2010, which requires member firms to “observe high standards of commercial honor and just and equitable principles of trade” in the conduct of their business.

Farmers Financial failed to reasonably supervise its VUL business.

A VUL is a hybrid product containing both insurance and securities features. VULs are long-term products that can provide coverage for the life of an insured and offer a death benefit payable on the death of the insured. VULs have an investment feature called the “cash value,” which refers to the underlying value of the investment portion of the VUL. VUL premium payments, which are paid throughout the life of the VUL, are allocated to investment subaccounts in order to increase the cash value. Monthly charges, including a cost of insurance charge and administrative fees, are deducted from the product’s cash value. The cash value of the VUL may increase or decrease based on the performance of the investment subaccounts. A VUL lapses if at any time the customer stops paying premiums and the cash value is insufficient to pay the monthly charges. If a VUL lapses, the customer is left with no insurance and no investment payout.

From June 2016 through December 2018, Farmers Financial sold approximately \$30 million in VULs, constituting approximately 30% of Farmers Financial’s revenues. During this period, Farmers Financial failed to establish and maintain a supervisory system reasonably designed to achieve compliance with applicable securities laws and regulations with respect to its VUL business. Specifically, the firm had information indicating that VUL policies were lapsing but failed to take reasonable steps to identify why the lapses occurred and whether the sales of VULs to the particular customers were suitable and to monitor the registered representatives involved.

If a VUL lapsed within certain time parameters set by the issuer, the VUL issuer would claw back the commission paid to the firm and registered representative. The firm’s Finance Department, as well as the registered representative’s direct supervisor, were aware when these clawbacks occurred. This information, however, was not shared with the firm’s principals who reviewed proposed VUL transactions.

¹ See FINRA Rule 2111.06 (Supplementary Material to Rule 2111).

In addition, the firm did not have any exception reports or other tools that would enable it to identify representatives with high lapse rates. Therefore, the firm could not identify and follow up on registered representatives with high lapse rates or unusual transaction patterns, such as selling new VULs to customers whose previous VULs had lapsed.

As a result of this unreasonable supervisory system, the firm did not identify a registered representative who had been working at the firm for two years, sold over 200 VULs and amassed a lapse rate of approximately 40%. The same representative also made repeat sales of VULs to customers whose VULs had previously lapsed, which the firm's system did not identify.

Therefore, Respondent violated FINRA Rules 3110(a) and 2010.²

Farmers Financial failed to reasonably supervise its mutual fund business.

The vast majority of mutual funds sold by Farmers Financial in 2016 and 2017 were Class A shares. Class A mutual fund shares typically include substantial upfront sales charges, known as “front-end loads.” They generally are suitable only as long-term investments and not as vehicles for short-term trading because an investor usually must hold A shares for a long period of time to account for the front-end load. Mutual fund “switching” occurs when a customer sells mutual fund shares and reinvests the proceeds in another mutual fund company, often incurring additional charges and commissions.

In addition, many issuers of front-end load mutual funds offer breakpoint discounts. Generally, an investor can procure a breakpoint discount through a single purchase large enough to reach a breakpoint or, in the alternative, through multiple purchases in either a single mutual fund or mutual fund family. Certain mutual funds also offer breakpoints after “householding” accounts, or by aggregating purchases in multiple accounts owned by the customer, or persons related to the customer.

From June 2016 through November 2017, Farmers Financial sold approximately \$11.5 million in mutual funds, constituting approximately 20% of the firm's revenue. Although new mutual fund accounts were directly opened with the issuer, the firm required its registered representatives to submit these accounts to firm principals for review and approval.

Farmers Financial failed to establish and maintain a supervisory system reasonably designed to achieve compliance with applicable securities laws and regulations with respect to its mutual fund business.

² The firm instituted reports in 2019 to track rates of VUL lapses.

The firm's primary tools to supervise its mutual fund business—the switch, breakpoint, and bypass reports—failed to constitute a reasonable supervisory system.

The firm used several exception reports to monitor its mutual fund business, including reports that identified potentially unsuitable mutual fund switch transactions (the switch report) and missed breakpoint discounts (the breakpoint report). Additionally, the firm used a bypass report to identify and follow up on instances where registered representatives opened new mutual fund accounts for customers with mutual fund companies without submitting them to firm principals, thereby bypassing the review and approval process. Farmers Financial had insufficient resources and relied on a manual review of the switch, breakpoint, and bypass reports.

The switch and breakpoint reports included inaccurate or incomplete information and had other data issues that further delayed their review. As an example, the switch report only flagged one-half of a transaction, (*i.e.*, just a purchase or a sale), which required reviewers to manually search for and review the other half in order to identify potentially unsuitable switches.

In another example, the breakpoint report often contained duplicate lines of data, which had to be manually cleared by surveillance staff prior to their review of the report. The breakpoint report also included inaccurate information in data fields that were critical to the identification of missed breakpoints, such as those that calculated total customer holdings and sales charges. Moreover, the breakpoint report did not categorize transactions by customer or household, nor did it include updated breakpoint criteria used by mutual fund companies. As a result, surveillance staff could not rely on the breakpoint report to determine whether customers received correct breakpoint discounts. Instead, surveillance staff first had to manually research and aggregate customer holdings in order to then perform a breakpoint calculation for each transaction on the report.

The bypass report consistently included hundreds of transactions per month. For eight months during the relevant period, there were over 300 transactions on each monthly report and in some cases, the number significantly exceeded that number. In order to follow up on transactions included on the bypass report, the surveillance team undertook an extensive manual review process. This included, among other things, contacting registered representatives, obtaining customer account documents, and tracking the registered representatives' responses over time.

Backlogs resulted from the firm's supervisory process.

During the relevant period, as a result of the issues described above, the firm was several months behind in its review of the switch, breakpoint, and bypass reports. Although senior management of the firm became aware of the backlog by at least May 2017, Farmers Financial did not implement any substantive improvements to its supervisory system during the relevant period and the backlog persisted. As a result, the firm failed to review hundreds of mutual fund transactions in a timely fashion.

Therefore, Respondent violated FINRA Rules 3110(a) and 2010.³

B. Respondent also consents to the imposition of the following sanctions:

- a censure and
- a \$100,000 fine.

Respondent agrees to pay the monetary sanction upon notice that this AWC has been accepted and that such payment is due and payable. Respondent has submitted an Election of Payment form showing the method by which it proposes to pay the fine imposed.

Respondent specifically and voluntarily waives any right to claim an inability to pay, now or at any time after the execution of this AWC, the monetary sanction imposed in this matter.

The sanctions imposed in this AWC shall be effective on a date set by FINRA.

II.

WAIVER OF PROCEDURAL RIGHTS

Respondent specifically and voluntarily waives the following rights granted under FINRA's Code of Procedure:

- A. To have a complaint issued specifying the allegations against it;
- B. To be notified of the complaint and have the opportunity to answer the allegations in writing;

³ Since November 2017, the firm has implemented technical improvements to the switch, breakpoint, and bypass reports and shifted responsibility for their review to a more experienced staff. In addition, in June 2020, the firm implemented an electronic platform for opening mutual fund accounts that prevents registered representatives from submitting platform eligible mutual fund accounts to mutual fund companies without review and approval by firm principals.

- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made, and to have a written decision issued; and
- D. To appeal any such decision to the National Adjudicatory Council (NAC) and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the Chief Legal Officer, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

Respondent understands that:

- A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs (ODA), pursuant to FINRA Rule 9216;
- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Respondent; and
- C. If accepted:
 - 1. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future action brought by FINRA or any other regulator against Respondent;
 - 2. this AWC will be made available through FINRA's public disclosure program in accordance with FINRA Rule 8313;
 - 3. FINRA may make a public announcement concerning this agreement and its subject matter in accordance with FINRA Rule 8313; and
 - 4. Respondent may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying,

directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. Respondent may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects Respondent's testimonial obligations or right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.

- D. Respondent may attach a corrective action statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this statement. This statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA.

The undersigned, on behalf of Respondent, certifies that a person duly authorized to act on Respondent's behalf has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that Respondent has agreed to the AWC's provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth in this AWC and the prospect of avoiding the issuance of a complaint, has been made to induce Respondent to submit this AWC.

May 24, 2021

Date

JOHN MUETING

Farmers Financial Solutions, LLC
Respondent

Print Name: JOHN MUETING

Title: President FFS

Reviewed by:

Brian L. Rubin

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Accepted by FINRA:

June 21, 2021

Date

Signed on behalf of the
Director of ODA, by delegated authority

Reema Abdelhamid

Reema Abdelhamid
Senior Counsel
FINRA
Department of Enforcement
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