

NASD
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. CE2050013

TO: Department of Enforcement
NASD

RE: John H. Herzog, Respondent
CRD No. 1515035

Pursuant to Rule 9216 of NASD Code of Procedure, Respondent John H. Herzog submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described in Part II below. This AWC is submitted on the condition that, if accepted, NASD will not bring any future actions against Respondent alleging violations based on the same factual findings.

Respondent understands that:

1. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by NASD's Department of Enforcement and National Adjudicatory Council ("NAC") Review Subcommittee or Office of Disciplinary Affairs ("ODA"), pursuant to NASD Rule 9216;
2. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Respondent; and
3. If accepted:
 - a. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future actions brought by NASD or any other regulator against him;
 - b. this AWC will be made available through NASD's public disclosure program in response to public inquiries about Respondent's disciplinary record;
 - c. NASD may make a public announcement concerning this agreement and the subject matter thereof in accordance with NASD Rule 8310 and IM-8310-2; and
 - d. 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 allegation in this AWC or creating the impression that the AWC is without factual basis. 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 NASD is not a party.

Respondent also understands that his experience in the securities industry and disciplinary history may be factors that will be considered in deciding whether to accept this AWC. That experience and history are as follows:

John H. Herzog entered the securities industry in March 1986, and was first registered as a General Securities Representative with an NASD member firm in June 1986. Herzog has been associated with LaSalle Street Securities, LLC ("LaSalle") since October 1989. At all times relevant to this AWC, Herzog was a General Securities Representative, General Securities Principal, and Branch Manager in a LaSalle branch office in Frankfort, Illinois. Herzog has no prior disciplinary history.

I.

WAIVER OF PROCEDURAL RIGHTS

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

- A. To have a Formal Complaint issued specifying the allegations against him;
- B. To be notified of the Formal Complaint and have the opportunity to answer the allegations in writing;
- 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 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 General Counsel, 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 acceptance or rejection of this AWC.

Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of Rule 9143 or the separation of functions prohibitions

of 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.

II.

ACCEPTANCE AND CONSENT

Respondent hereby accepts and consents, without admitting or denying the allegations or findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of NASD, or to which NASD 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 NASD:

Summary and Background

1. This matter involves violations of NASD Rules in connection with market timing activity effected by Herzog through LaSalle on behalf of a hedge fund customer of LaSalle. Market timing refers to the practice of short term buying and selling of mutual fund shares in order to exploit inefficiencies in the pricing of those shares. Market timing is accomplished either through purchases and redemptions of mutual fund shares from the mutual fund company or from mutual fund sub-accounts of variable annuities.
2. From September 2002 through December 2002, Herzog facilitated deceptive practices regarding market timing in the sub-accounts of variable annuities for a hedge fund client that purported to manage money for wealthy individuals and corporate entities they established for that purpose (the "Hedge Fund Client"). The Hedge Fund Client used a number of different accounts to purchase variable annuity contracts from Hartford Life and Annuity Insurance Company ("Hartford Life"). Herzog enabled the Hedge Fund Client to use these accounts to carry out frequent transfers among the sub-accounts of variable annuities without being detected by Hartford Life or by mutual fund managers, despite their attempts to enforce restrictions on market timing to protect the interests of long-term investors. Herzog continued to process orders to sell variable annuity policies for the Hedge Fund Client after receiving written notice from Hartford Life that it considered the client's trading strategy to be disruptive and contrary to the interests of long-term investors.
3. In the spring of 2003, Herzog received a one-time payment of \$44,300.22 through AMIC, his registered independent investment advisory firm, which it in turn had received from the Hedge Fund Client. The payment was to compensate Herzog in part for commissions that were charged back to Herzog after the underlying variable annuity contracts were surrendered by the Hedge Fund Client within the first year as well as for certain expenses incurred in connection with the variable annuity business of the Hedge Fund Client.

4. Herzog's conduct in facilitating the deceptive practices of the Hedge Fund Client regarding market timing was contrary to high standards of commercial honor and just and equitable principles of trade, and therefore violated NASD Conduct Rule 2110.

Market Timing Within the Sub-Accounts of Variable Annuities

5. As described above, "market timing" is the practice of short term buying and selling of mutual fund shares to exploit inefficiencies in mutual fund pricing. Unlike securities listed on an exchange, the "net asset value" or NAV of a mutual fund currently is calculated only once per day, at 4:00 p.m. EST. This regimen for determining NAV provides market timers the opportunity to engage in arbitrage based on market information not reflected in that day's net asset value. To do this, market timers typically buy and sell shares in mutual funds on a short-term basis, realizing quick gains and then retreating to the previous market position. Market timing is not illegal *per se*. It can harm mutual fund shareholders, however, because it can dilute the value of their shares, by, among other things, requiring the fund to keep a larger percentage of highly liquid assets to cover the redemptions, or by increasing the transaction costs for the fund. Long-term fund investors may ultimately bear the burden of paying these costs. In addition, trading profits obtained by market timers can result in losses to mutual fund shareholders. Mutual funds generally maintain policies and procedures to detect and prevent market timing.
6. Sub-accounts of variable annuities often provide an attractive investment vehicle for market timing organizations, because variable annuities offer a level of anonymity not available to market timers dealing directly with mutual funds. Investors in variable annuities do not initiate purchases and redemptions of shares directly with the mutual fund company; rather, investors in annuities are permitted to allocate invested funds among a variety of mutual fund "sub-accounts." Rather than purchasing and redeeming funds directly from the mutual fund company, investors in annuities instruct the insurance company to transfer funds from one sub-account to another. The insurance company, in turn, initiates and monitors purchases and redemptions of mutual fund shares once per day on an "omnibus" basis for numerous clients. As a result, mutual fund companies do not have direct access to the identities of individual investors who have requested transfers of funds among the sub-accounts, complicating the efforts of the mutual fund companies to detect excessive market timing by any given investor.
7. To guard against the adverse impact of market timers on the long-term shareholders of sub-account mutual funds, insurance companies that sell variable annuities generally maintain policies and procedures to detect and prevent market timing. Moreover, the prospectuses that govern variable annuity contracts typically state that variable annuity products are not designed for market timing.

For example, the prospectus governing the Hartford Life “Director Access” annuity offered through LaSalle stated:

This Contract is not designed to serve as a vehicle for frequent trading in response to short-term fluctuations in the stock market. Any individual or legal entity that intends to engage in international arbitrage, utilize market timing practices or make frequent transfers to take advantage of inefficiencies in Fund pricing should not purchase this Contract. These abusive or disruptive transfers can have an adverse impact on management of a Fund, increase Fund expenses and affect Fund performance.

Herzog’s Relationship with the Hedge Fund Client

8. In or about late spring 2002, Herzog formed a relationship with the Hedge Fund Client. The trading strategy of the Hedge Fund Client included, in part, market timing in mutual funds within sub-accounts of variable annuities.
9. Herzog should have known in or before September 2002 that the Hedge Fund Client was engaged in market timing activities, and that it intended to open accounts for various corporate entities and individuals through Herzog for the purpose of executing a market timing strategy within the sub-accounts of variable annuities. Herzog knew at that time that the Hedge Fund Client was interested in purchasing annuities that did not impose surrender charges if closed within the first calendar year after the contract was opened. In June 2002, Herzog, through his registered independent investment advisory firm, and the Hedge Fund Client entered into an agreement under which the Hedge Fund Client would reimburse the investment advisory firm for “the full amount of any charges incurred from surrendering of annuity contracts, if because of action taken by the insurer or by the request of” the Hedge Fund Client.
10. The Hedge Fund Client’s accounts were transferred to Herzog and LaSalle from another firm. Prior to that transfer, the registered representatives who handled the accounts told Herzog that the firm was no longer able to do business with the Hedge Fund Client’s accounts.
11. Herzog also knew that prospectuses that governed annuity products offered through LaSalle, including the Hartford Life Director Access annuities, stated that the relevant annuities were designed for long-term investors and were not designed for market timing.
12. Herzog received at least 13 letters from Hartford Life, on or before September 19, 2002, notifying him that market timing and excessive transfers among sub-accounts by the Hedge Fund Client were disruptive to the underlying funds, harmed long-term investors, and increased costs to the funds.

13. Despite this information, Herzog facilitated deceptive practices, as described below, regarding market timing, and continued to process orders to sell Hartford Life and other variable annuity products for the Hedge Fund Client while knowing that the Hedge Fund Client intended to engage in trading patterns that Hartford Life had previously stated would be disruptive and harmful.
14. Herzog also received a one-time payment of \$44,300.22 through AMIC, his registered independent investment advisory firm, which in turn had received from the Hedge Fund Client. The payment was to compensate Herzog in part for commissions that were charged back to Herzog after the underlying variable annuity contracts were surrendered by the Hedge Fund Client within the first year, as well as for certain expenses incurred in connection with the variable annuity business of the Hedge Fund Client.

Hartford Life

15. During the relevant period, the prospectus for Hartford Life's "Director Access" variable annuities set forth a transfer policy that was "designed to protect Contract Owners from abusive or disruptive trading activity." The policy permitted twenty sub-account transfers per year placed by telephone, internet or facsimile. Any additional transfers in a calendar year could only be placed by U.S. mail or overnight delivery service. The prospectus further provided:

Regardless of the number of transfers you have made, we will monitor Sub-Account transfers and we may terminate your transfer privileges until your next Contract Anniversary if we determine that you are engaging in a pattern of transfers that is disadvantageous or potentially harmful to other Contract Owners.

The prospectus stated that Hartford Life would consider the dollar amount of the transfer, the total assets of the Funds involved, the number of transfers already completed in the current calendar quarter, and "whether the transfer is part of a pattern of transfers designed to take advantage of short term market fluctuations or market inefficiencies." The prospectus also stated that additional transfer restrictions could be placed on contracts funded with an initial deposit of \$1 million or more.

16. Between August 2002 and December 2002, Herzog arranged for sub-account transfers, on behalf of the Hedge Fund Client, in at least 25 Hartford Life "Director Access" annuities. Those annuities were held in the names of five different limited liability corporations managed by the Hedge Fund Client. Some of those contracts were initially funded at another firm and transferred to LaSalle. The annuitant on each contract was an individual Herzog knew or should have known to be employed by or associated with the Hedge Fund Client. Five of the

contracts were funded with initial deposits of \$980,000, \$980,000, \$960,000, \$873,000, and \$867,000, thereby avoiding Hartford Life's additional transfer restrictions on contracts initially funded with \$1 million or more.

17. On ten of the 25 annuity contracts, Herzog received a written restriction letter from Hartford Life within two to seven weeks after the contract was initially funded. Four of the ten contracts were restricted after effecting ten to fourteen transfers in less than one month. Six additional contracts were restricted after making between six and eight transfers due to the dollar amount of the transfers and their effect on the fund's liquidity. Nonetheless, after Hartford Life notified Herzog that it was exercising its contractual right to terminate transfer privileges on those contracts, on at least three occasions Herzog submitted new applications to Hartford Life for the same product on behalf of the same business entities, sometimes listing another employee of the Hedge Fund Client as the annuitant, and sometimes using different corporate identities with different account numbers and tax ID numbers in an attempt to avoid detection as a market timer. In fact, the annuitants were officers or employees of the Hedge Fund Client. This conduct was intended to deceive Hartford Life and allow the Hedge Fund Client to continue trading Hartford Life contracts, notwithstanding Hartford Life's efforts to stop that trading. As Herzog knew, and as Hartford Life had stated in its prospectuses and restriction letters, the continued trading activity was harmful to Hartford Life's contract owners.
18. Herzog's conduct as set forth above was contrary to high standards of commercial honor and just and equitable principles of trade, and therefore violated NASD Conduct Rule 2110.

SANCTIONS

Respondent Herzog consents to the imposition, at a maximum, of the following sanctions:

1. a fine of \$59,300.22, which includes disgorgement of \$44,300.22, representing the payment made to Herzog to reimburse him in part for commissions charged back as a result of market timing activity and to pay him for certain expenses incurred in connection with the variable annuity business of the Hedge Fund Client; and
2. suspension from association with any NASD member firm in all capacities for ninety (90) days.

The sanctions imposed herein shall be effective on a date set by NASD staff.

III.

OTHER MATTERS

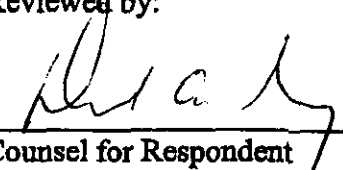
- A. Respondent understands that he may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that he may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by NASD, nor does it reflect the views of NASD or its staff.
- B. Respondent agrees to pay any monetary sanctions imposed on him upon reentry as noted above, and has attached an Election of Payment form showing the method by which he proposes to pay any fine imposed.
- C. Respondent specifically and voluntarily waives any right to claim that he is unable to pay, now or at any time hereafter, any monetary sanction imposed in this matter.

Respondent certifies that he has read and understand all of the provisions of this AWC and has been given a full opportunity to ask questions about it, and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein, has been made to induce Respondent to submit it.

Date: 6-13-05

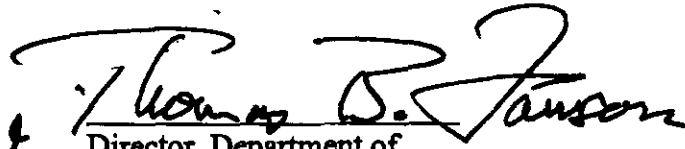

John H. Herzog

Reviewed by:


Counsel for Respondent

Accepted by NASD:

6/22/05
Date


Thomas B. Janson
Director, Department of
Enforcement

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