

NASD
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. EAF0400610003

TO: Department of Enforcement
NASD

RE: Linsco Private Ledger Corp., Respondent
CRD No. 6413

Pursuant to Rule 9216 of NASD Code of Procedure, Respondent 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 it;
 - 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

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- 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 create 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 its experience in the securities industry and any applicable disciplinary history may be factors that will be considered in deciding whether to accept this AWC. That experience and history are as follows:

Linsco Private Ledger Corp. ("LPL" or the "firm") has been an NASD member firm since 1973. The firm, which is headquartered in Boston, Massachusetts, has in excess of 6,100 registered representatives and approximately 3,300 registered branch offices nationwide. LPL conducts a general securities business on a self-clearing basis. LPL has the following applicable disciplinary history: On May 24, 2005, LPL entered into an AWC with NASD, in which it agreed to a censure and a fine of \$2.4 million for suitability and supervisory violations relating to sales of Class B and Class C shares of mutual funds.

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 Respondent;
- 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

- 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 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

During the period January 1, 2003, to December 31, 2004 ("the review period"), LPL violated NASD Conduct Rules 3010 and 2110 by failing to establish, maintain, and enforce an adequate supervisory system, including written procedures, reasonably designed to review and monitor its variable annuity exchange business.

LPL's supervisory system also relied, in significant part, upon automated, coded reports to evaluate its variable annuity exchanges. For all or part of the review period, those automated reports failed to capture certain information necessary for the proper evaluation of exchanges, such as whether a death benefit was lost, a comparison of contract charges, and a detailed reason for the exchange. In addition, LPL registered representatives occasionally failed to code their exchange transactions correctly on the automated reports, which may have caused compliance analysts not to identify and review certain transactions as exchanges.

LPL's policies and procedures called for the review of variable annuity transactions, including all exchanges, by registered principals as follows: Office of Supervisory Jurisdiction ("OSJ") principals performed the initial review and approval of variable annuity exchange transactions submitted by registered representatives under their supervision (including registered representatives working at non-OSJ branch locations). Compliance Analysts in the LPL Compliance Department reviewed and approved variable annuity exchange transactions submitted by OSJ principals. Registered principals in the firm's Compliance Department also examined certain

transactions listed on surveillance reports utilized by LPL to identify transactions that might warrant additional supervisory review. In reviewing variable annuity exchange transactions, these OSJ principals and Compliance Department principals had available to them various sources of relevant information, including new account documentation, account records, applications and transactional paperwork, prospectuses or other offering documents, customer correspondence and registered representative notes. However, the firm's written policies and procedures did not require that its principals utilize these sources of information and the firm did not provide adequate guidance to its principals regarding when or how to utilize some of such information.

LPL's written procedures also provided insufficient guidance to compliance analysts in assessing the suitability of a variable annuity exchange. The procedures suggested that analysts review certain categories of information, such as investment objectives, age, and financial information. The procedures also suggested that analysts further review a variable annuity exchange if it met certain parameters. However, in some cases, certain information needed for the review, such as, whether the OSJ principal or registered representative was the agent of record on the original contract that was being exchanged and whether the facts and circumstances of each transaction supported the rationale for the exchange, was not readily available to supervisory personnel.

In light of these and other supervisory deficiencies relating to variable annuity exchanges, as discussed below, LPL violated NASD Rules 3010 and 2110.

Background

A variable annuity is an insurance contract that offers a range of investment options for the owner. Generally, most variable annuities are designed to be long-term investments for retirement. The value of a variable annuity will vary depending upon the performance of the investments chosen. Because the contract owner assumes the investment risks, variable annuities are securities and generally must be registered under the Securities Act of 1933.

The investment options for variable annuities offered in "subaccounts" are typically mutual funds that invest in stocks, bonds, money market instruments, or some combination of the three. Although variable annuities offer investment features similar to mutual funds, variable annuities offer certain basic features not ordinarily found in mutual funds. First, earnings in a variable annuity are tax-deferred. As such, the customer pays no taxes upon the income and investment gains from the annuity until the customer withdraws his or her money. The customer may also transfer his or her money from one investment option or subaccount to another within a variable annuity without paying taxes at the time of the transfer. When money is withdrawn from a variable annuity, however, the customer will be taxed upon the earnings at ordinary income rates rather than lower capital gains rates. In general, the benefits of tax deferral will outweigh the costs of a variable annuity only if the customer holds it as a

long-term investment to meet retirement or other long-range goals.¹

Second, a variable annuity provides annuity payout options that can provide a guaranteed periodic payment for the rest of the customer's life (or the life of the customer's spouse or other designated person). Third, a variable annuity offers a death benefit. If the customer dies before the insurer has started making payments to the customer, the designated beneficiary is guaranteed to receive a specified amount – typically, at least the amount of the customer's purchase payments. The beneficiary will receive a benefit from this feature if, at the time of the customer's death, the customer's account value is less than the guaranteed amount. Upon death, however, the beneficiary of the variable annuity does not benefit from a stepped-up tax basis on the assets.

A variable annuity has two phases: an accumulation phase and a distribution phase. During the accumulation phase, a customer makes purchase payments, which can be allocated to a number of investment options. During the accumulation phase, a customer also can transfer money from one investment option to another without paying tax on his or her investment income and gains, although the insurance company may charge the customer for the transfers. However, if a customer withdraws money from the account during the early years of the accumulation phase, he or she may have to pay "surrender charges." In addition, the customer may have to pay a 10 percent federal tax penalty if he or she withdraws money prior to the age of 59½. During the distribution phase, a customer withdraws money from the variable annuity either as a lump-sum payment or as a stream of payments at regular intervals (generally monthly). Some annuity contracts are structured as immediate annuities, where there is no accumulation phase and the customer will start receiving annuity payments immediately after he or she purchases the annuity.

Section 1035 of the United States tax code allows a customer to exchange an existing variable annuity contract for a new annuity contract without paying any tax on the income and investment gains in the customer's current variable annuity account. Such tax-free exchanges, known as 1035 exchanges, can be beneficial to the customer if another annuity has features preferred by the customer, such as a larger death benefit, different annuity payout options, or a wider selection of investment choices. The customer may, however, be required to pay surrender charges on the old annuity if he or she is still in the surrender charge period at the time of the exchange. In addition, a new surrender charge period generally begins when the customer exchanges into the new annuity. This means that, for a significant number of years (as many as 10 years), the customer typically will have to pay a surrender charge (which can be as high as nine percent of the customer's purchase payments) if the customer withdraws funds from the new annuity. Also, the new annuity may have higher annual fees and charges than the old annuity, which will reduce the customer's returns. Because of these potential costs, lost death benefits, and loss of liquidity, exchanges must be evaluated closely to determine whether the exchange is suitable for the customer.

¹ If a customer invests in a variable annuity through a tax-advantaged retirement plan (such as a 401(k) plan or IRA), the customer will get no additional tax advantage from the variable annuity.

A registered representative who makes a recommendation to a customer is required by NASD Conduct Rule 2310(a) to have "reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." In order to fulfill the suitability requirement for variable annuity exchanges, brokers must determine that "replacing the existing contract with a new contract is suitable for the customer."² This means that a broker can recommend a variable annuity exchange only if it is in the customer's best interest and only after evaluating the customer's personal and financial situation and needs, tolerance for risk, and the financial ability to pay for the proposed contract.

As explained more fully below, there were several flaws with LPL's supervisory system and procedures that caused the firm not to conduct an adequate suitability review of certain variable annuity exchange transactions. As a result, LPL violated NASD Conduct Rules 3010 and 2110.

**LPL Failed to Establish and Maintain a Supervisory System,
Including Written Procedures, Reasonably Designed
to Review and Monitor Its Variable Annuity Exchanges**

NASD Conduct Rule 3010 requires firms to establish and maintain a supervisory system, including written supervisory procedures ("WSPs"), to supervise the activities of its registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations and NASD Rules.

LPL violated NASD Conduct Rules 3010 and 2110 by failing to establish and maintain a supervisory system, including written procedures, reasonably designed to review and monitor its variable annuity exchanges. The deficiencies relating to LPL's variable annuity exchanges generally fell into the following categories: (1) inadequate automated systems and written procedures for exchanges reported on the Branch Trade Report ("BTR") and Trade Blotter; and (2) an inadequate system and procedures for the review of "red flag" exchanges reported on the firm's Suitability Report.

**LPL's Automated Systems And Written Procedures For Variable Annuity
Exchanges Reported on the BTR and Trade Blotter Were Inadequate**

During the review period, LPL registered representatives or their administrative staff entered information concerning all variable annuity exchanges directly on the firm's automated BTR.³ Until March 2004, the BTR lacked some necessary information for an adequate review of variable annuity exchanges, such as detailed information about the

² See Notice to Members ("NTM") 99-35 (May 1995). NTM 99-35 also outlines other relevant responsibilities for members with regard to the sales and exchanges of variable annuities and provides guidelines for developing systems and procedures to supervise such sales and exchanges.

³ According to the firm's written procedures, only registered representatives were to enter variable annuity exchange information on the BTR.

surrendered contract, customer liquidity, fees and expenses of the old and new contracts, lost death benefits, and the reason for the switch. As a result, the transaction codes entered on the BTR provided insufficient information and failed to address any of the above issues.

In March 2004, the firm added a field on the BTR entitled, "switch reason," which called for registered representatives to enter a limited number of codes – for example, a code "6" denoted "enhanced product features," while a code "10" simply represented "other." At no time did information regarding riders appear on the BTR.

LPL did not provide adequate training to registered representatives regarding the entry of transactions into this system and the firm failed reasonably to ensure that its registered representatives (or administrative staff) were correctly entering information about variable annuity exchanges on the BTR. As a result, certain LPL registered representatives reported exchanges inconsistently, sometimes correctly identifying them as exchanges using the proper code, and sometimes identifying them incorrectly, as "product liquidation," "partial liquidation," "initial investment" or using other improper codes.⁴ Other registered representatives simply failed to provide information in all the designated fields.

The firm had different procedures for the review of variable annuity exchanges, depending upon whether the exchange was submitted by a producing OSJ principal or another registered representative. Branch managers conducted supervisory reviews of exchanges by advisors who were assigned to their supervision, while the Compliance Department of LPL's home office conducted supervisory reviews of exchanges submitted by producing OSJ principals.

Under LPL's procedures, the initial review and approval of variable annuity exchanges submitted by registered representatives who were not OSJ principals was conducted by a branch manager, who used either the BTR or the branch office's Trade Blotter. The Trade Blotter, like the BTR, was not limited to exchanges. It included all transactions done within a branch office. The Trade Blotter, however, had fewer fields than the BTR and contained no fields specific to variable annuities.

LPL's procedures mandated that reviews of variable annuity exchanges submitted by producing OSJ principals were conducted by LPL's home office Compliance Department using the BTR. The procedures provided only general guidance to compliance analysts in assessing the suitability of an exchange. Although LPL made available to its compliance analysts various resources to evaluate the

⁴ For example, during the review period, one registered representative entered 14 exchange transactions on the BTR and improperly coded each of them. Specifically, none of the transactions included a code for the switch reason, identified a surrender charge, or was coded as a variable annuity exchange transaction. Most of the 14 exchanges had surrender charges, including one as high as \$22,000, but that information was not readily available to the principal who reviewed and approved the transactions.

suitability of variable annuity exchanges,⁵ the firm's written procedures did not require analysts to obtain additional information or documentation (e.g., a switch letter) from OSJ principals regarding the net financial benefit of the exchange to the customer. Further, the firm did not provide adequate guidance to its analysts regarding when and how to utilize the various resources available to them. Similarly, analysts were not required to request additional information for exchanges that met certain parameters (e.g., age, net worth). Even if there were such requirements, much of the information necessary for the analysis (i.e., whether the registered representative was the agent of record on the original contract being exchanged and whether the facts and circumstances supported the rationale for the exchange) was not readily available to the analysts on the BTR.

**LPL's System and Procedures for the Review of "Red Flag"
Exchanges Reported on the Suitability Report Were Also Inadequate**

LPL's written procedures set forth a number of "red flag" criteria to identify variable annuity exchanges that warranted further attention. LPL implemented an automated system to monitor potential "red flag" transactions, through the creation of a Suitability Report. Information contained in the Suitability Report was taken directly from information entered into the BTR. The Suitability Report was an exception report, which was printed on a daily basis and utilized to surveil direct business transactions, including variable annuity transactions, reported on the BTR. Similar to the BTR, throughout the review period, the Suitability Report used codes for certain categories relevant to the variable annuity transactions, but lacked details regarding lost death benefits, specific reasons for switches, cost structures, and critical information about the surrendered product. At no time did information regarding riders appear on the Suitability Report. All exchange transactions that met certain designated criteria were captured on the Suitability Report. Some examples of these criteria included: age greater or equal to 70 and transaction value greater or equal to \$100,000, and surrender charge in excess of two percent and CDSC (Contingent Deferred Sales Charge) greater than or equal to \$1,000. Throughout most of the relevant period, until March 2004, the Suitability Report did not provide fields for information regarding the liquidated product, the source of funds, or the switch reason.

In addition to their routine reviews of variable annuity exchange transactions, principals in LPL's Compliance Department selected some, but not all, transactions on the Suitability Report for further review. Nonetheless, during the review period, LPL's reliance on the BTR as a supervisory tool with respect to some variable annuity exchange transactions, coupled with its failures to submit certain exchanges to further and more thorough supervisory reviews based upon the Suitability Report, rendered its supervisory systems and procedures inadequate.

⁵ Among the materials that OSJ principals or compliance analysts obtained for the review of variable annuity exchange transactions were: prospectuses, insurance contracts, historical account records or other materials, including, in some cases, the handwritten notes of the registered representative.

LPL failed reasonably to provide for an adequate supervisory review of certain transactions that appeared on the Suitability Report. LPL compliance analysts selected for further supervisory review a sample of transactions that appeared on the Suitability Report. In some cases, unless a variable annuity exchange transaction appeared on the Suitability Report and was selected for further supervisory review by a compliance analyst, no principal may have reviewed the exchange other than by looking at the BTR. Moreover, in certain instances, the firm's use of the Suitability Report failed reasonably to ensure an appropriate review of variable annuity exchange transactions. For example, one exchange listed on the BTR did not reflect any surrender charges. When the exchange later appeared on the Suitability Report, it indicated surrender charges of 1.7 percent (which amounted to \$13,853). In actuality, the surrender charges were 2.7 percent (which amounted to \$22,027). This was reflected in the registered representative's paperwork, which apparently was not reviewed by the compliance analysts during the ordinary course of business.

Although compliance analysts could request additional information from the registered representative who conducted the selected transaction, the firm's written procedures did not require analysts to obtain specific additional information. In particular, information, such as the investment application, prospectus receipt, switch letter, and explanation of the product features of the annuity, was suggested for follow-up review, but was not required.

Further, although LPL's internal written procedures directed analysts to look for patterns suggesting improper replacement activity, the analysts were not aided in this effort by specific computer or electronic tracking systems. Accordingly, in some cases, analysts were required to rely upon their memory in identifying patterns of potentially inappropriate activity. Given the large volume of transactions reviewed by each analyst, this made identifying patterns of potentially improper and/or frequent replacement activity more difficult or unlikely.

Conclusion

For the reasons described above, LPL's system and procedures were not reasonably designed to conduct an adequate suitability review of variable annuity exchanges. Accordingly, LPL violated NASD Rules 3010(a) and (b) and 2110 by failing to establish, maintain, and enforce a supervisory system, including written procedures, reasonably designed to review and monitor its variable annuity exchange business.

- B. Respondent also consents to the imposition, at a maximum, of the following sanctions:
 - 1. A censure;
 - 2. A fine of \$300,000;

3. An undertaking as described below:
- a. Since the start of the review period, LPL has implemented new procedures and made improvements to its systems and procedures for reviewing variable annuity exchanges. Additional updates to LPL's systems and procedures are currently underway. These implemented or contemplated improvements include:
 - 1. a centralized online order-entry system designed to standardize and enhance the firm's overall review of variable annuity exchanges before they are submitted to product sponsors;
 - 2. the standardized use and review of additional suitability data with respect to variable annuity exchanges; and
 - 3. related revisions or amendments to LPL's written supervisory procedures regarding variable annuity exchanges.

NASD has considered these new procedures and systems improvements in determining to accept this AWC.

- a. LPL shall:
 - (i) Retain, within six months from the date of this AWC, an Independent Consultant, not unacceptable to NASD staff, to conduct a review to determine whether the improvements described above have been appropriately implemented, whether supervisory personnel are conducting the reviews as prescribed and documenting their efforts, and whether the systems and procedures are adequate.
 - (ii) Exclusively bear all costs, including compensation and expenses, associated with the retention of the Independent Consultant.
 - (iii) Cooperate with the Independent Consultant in all respects, including by providing staff support. LPL shall place no restrictions on the Independent Consultant's communications with NASD staff and, upon request, shall make available to NASD staff any and all communications between the Independent Consultant and the firm and documents reviewed by the Independent Consultant in connection with his or her engagement. Once retained, LPL shall not terminate the relationship with the Independent Consultant without the NASD staff's written approval; LPL shall not be in and shall not have an attorney-client relationship with the Independent Consultant and shall not seek to invoke the attorney client privilege or other doctrine or privilege to prevent the Independent Consultant from transmitting any information, reports or documents to the NASD.

- (iv) At the conclusion of the review, which shall be no more than four months after the Consultant is retained, require the Independent Consultant to submit to the firm and NASD staff a Written Report. The Written Report shall address, at a minimum: the adequacy of the firm's existing policies, systems, procedures and training relating to variable annuity exchanges, including: (i) whether the improvements described above have been appropriately implemented; (ii) the adequacy of documentation of reviews being performed pursuant to the improvements; (iii) a description of the reviews being performed and the conclusions reached, and (iv) the Independent Consultant's recommendations, if any, for modifications or additions to the firm's existing policies, systems, procedures and training regarding the implementation of the improvements, the performance of supervisory personnel reviewing the transactions, and the adequacy of documentation of the reviews.
- (v) Require the Independent Consultant to enter into a written agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter in to any other employment, consultant, attorney-client, auditing or other professional relationship with LPL, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. Any firm with which the Independent Consultant is affiliated in performing his or her duties pursuant to this AWC shall not, without prior written consent of the NASD staff, enter in to any employment, consultant, attorney-client, auditing or other professional relationship with LPL or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.
- b. Within 90 days after delivery of the Written Report, LPL shall adopt and implement the recommendations (if any) of the Independent Consultant or, if it determines that a recommendation is unduly burdensome or impractical, propose an alternative procedure to the Independent Consultant designed to achieve the same objective. The firm shall submit such proposed alternatives in writing simultaneously to the Independent Consultant and the NASD staff. Within 30 days of receipt of any proposed alternative procedure, the Independent Consultant shall: (i) reasonably evaluate the alternative procedure and determine whether it will achieve the same objective as the Independent Consultant's original recommendation, and (ii) provide the firm with a written decision

reflecting his or her determination. The firm will abide by the Independent Consultant's ultimate determination with respect to any proposed alternative procedure and must adopt and implement all recommendations deemed appropriate by the Independent Consultant.

- c. Within 30 days after the issuance of the later of the Independent Consultant's Written Report or written determination regarding alternative or modified procedures (if any), LPL shall provide the NASD staff with a written implementation report, certified by an officer of LPL, attesting to, containing documentation of, and setting forth the details of the firm's implementation of the Independent Consultant's recommendations.
- d. Within 90 days after the issuance of the later of the Independent Consultant's Written Report or written determination regarding alternative or modified procedures (if any), LPL shall certify that it has provided the following training relating to the firm's automated supervisory systems for reviewing and monitoring variable annuity transactions: (1) training for all of the Firm's registered persons on how to correctly input information for use by the firm's automated supervisory systems; and (2) training for all of the firm's principals responsible for reviewing and approving variable annuity transactions on how to utilize and interpret the reports generated by the firm's automated supervisory systems in order to properly review and monitor variable annuity transactions.
- e. Upon written request showing good cause, the NASD staff may extend any of the procedural dates set forth above.

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

III.

OTHER MATTERS

- A. Respondent understands that it 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 NASD, nor does it reflect the views of NASD or its staff.
- B. Respondent agrees to pay any monetary sanctions imposed on it upon notice that this AWC has been accepted and that such payments are due

and payable and has attached an Election of Payment form showing the method by which Respondent proposes to pay any fine imposed.

- C. Respondent specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, any monetary sanction imposed in this matter.

Respondent certifies that it has read and understands 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.

Linsco Private Ledger Corp.

December 4, 2006
Date

By: Stephanie L. Brown
Stephanie L. Brown
Managing Director/General Counsel

Reviewed by:

Stephen G. Topetzes
Stephen G. Topetzes
Kirkpatrick & Lockhart Nicholson Graham LLP

Accepted by NASD:

December 21, 2006
Date

Samuel L. Israel
Samuel L. Israel, Chief Counsel
Enforcement
Signed on behalf of the Director of
ODA, by delegated authority