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ADMIN HEARINGS OFFICE

IN THE MATTER OF THE *

MULTI-STATE EXAMINATION OF *
WADDELL & REED INC *
W & R INSURANCE AGENCY INC *
6300 Lamar Avenue *
Shawnee Mission, Kansas 66202 *

CONSENT ORDER

Docket No. CO05-07-016

* * * * *

This Consent Order is hereby issued by the Pennsylvania Insurance Department (the "Department") in disposition of the matter captioned above.

FINDINGS OF FACT

1. Respondent W & R Insurance Agency Inc., hereinafter "Waddell & Reed", is a licensed insurance agency in the Commonwealth of Pennsylvania with Non-resident Producer License Number 60692.
2. The States of Kansas and Minnesota (the "Lead States") coordinated a multi-state investigation of the Respondent with regard to variable annuity sales practices in connection with Respondent encouraging existing customers who held variable annuity products to surrender the products and to purchase similar products issued by a different insurer. The Lead States participated in and coordinated the negotiation and finalization of the regulatory settlement between Respondent and the states participating therein.
3. As a result of the investigation the Lead States alleged that the Respondent's variable annuity sales practices were in violation of the insurance laws of the Lead states. The Respondent neither admits nor denies the allegations.
4. Respondent is licensed to engage in the business of insurance in this state. As affecting this state, the Department has jurisdiction over the subject matter of this proceeding and Respondent.
5. A proposed settlement has been presented to the Department, the terms of which are set forth in KS Consent Order 3468-CO and MN Consent Order (the "Kansas and Minnesota Consent Order") dated June 10, 2005, which has been executed by Respondent, the Kansas Insurance Department, and the Minnesota Department of Commerce, in their capacity as two of the primary negotiators, a copy of which is attached hereto as Exhibit A.

6. Upon review of the Kansas and Minnesota Consent Order, it is found that it is a fair and proper disposition of the matters addressed therein.

ORDER

WHEREAS it is stipulated and agreed upon by and between the Department and Respondent and **ORDERED** as follows:

- A. The Kansas and Minnesota Consent Order dated June 10, 2005, attached hereto as Exhibit A is incorporated herein by reference, adopted fully, and is hereby approved.
- B. Respondent shall immediately initiate compliance with all terms and conditions of the Kansas and Minnesota Consent Order as incorporated herein.

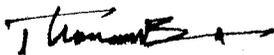
IN WITNESS WHEREOF, the Department and Respondent have executed this Consent Order.

Consented to in form and content:

WADDELL & REED INC.
W & R INSURANCE AGENCY INC.

PENNSYLVANIA INSURANCE
DEPARTMENT

BY:



Signature

BY:



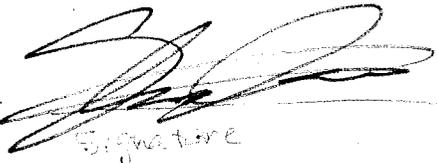
Thomas Buten
Name

DIANE KOKEN
Name

President and Chairman of
Title the Board of Directors, Inc.

INSURANCE COMMISSIONER
Title

By:



Signature

Steve Anderson
Name

August 15, 2005
Date

President W & R Insurance Agency, Inc
Title

EXHIBIT A

**BEFORE THE COMMISSIONER OF INSURANCE
OF THE STATE OF KANSAS**

**STATE OF MINNESOTA
DEPARTMENT OF COMMERCE**

IN THE MATTER OF:

**WADDELL & REED, INC. and
W & R INSURANCE AGENCY, INC**
6300 Lamar Avenue
Shawnee Mission, KS 66202

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) **CONSENT ORDER**

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) **KS Docket No 3468-CO**

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) **MN _____**
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WHEREAS, Waddell & Reed, Inc. ("Waddell & Reed") is a broker-dealer registered in the States of Kansas and Minnesota, and

WHEREAS, W & R INSURANCE AGENCY, INC., (hereinafter "Waddell & Reed") is a licensed insurance agency in Kansas and Minnesota; and

WHEREAS, coordinated investigations have been conducted by members of a multi-state group of securities and insurance regulators into Waddell & Reed's suitability determinations and sales practices regarding variable annuity investments, and

WHEREAS, Waddell & Reed has provided information to regulators conducting the investigations by responding to inquiries, providing documentary evidence and other materials,

and providing regulators with access to facts relating to the investigations and has entered into a separate settlement with the NASD relating to the challenged conduct; and

WHEREAS, Waddell & Reed had advised regulators of its agreement to resolve the investigations relating to the exchange of variable annuity investments; and

WHEREAS, Waddell & Reed agrees to implementation of a restitution plan to provide compensation to customers affected by its variable annuity exchange program, to implement changes to its sales practices, and to make certain payments; and

WHEREAS, Waddell & Reed elects permanently to waive any right to a hearing and appeal under K.S.A. 77-501 *et. seq.*, the Kansas Administrative Procedures Act, and/or K.S.A. 77-601 *et. seq.*, the Act for Judicial Review and Civil Enforcement of Agency Actions and Minn. Stat., §§ 45.027 and 60K.43 with respect to this Consent Order (the "Order");

NOW, THEREFORE, the Kansas Insurance Department pursuant to the Insurance Code of the State of Kansas K.S.A. 40-101 *et. seq.*, and the Minnesota Department of Commerce pursuant to Minn. Stat., § 45.027 hereby enter this Order:

I. FINDINGS OF FACT

A. Jurisdiction

1. Waddell & Reed, Inc. (CRD No. 866) is currently and, at all times relevant to this Order was registered in Minnesota as a broker-dealer. Waddell & Reed is also a federal-covered investment adviser.
2. W&R Insurance Agency, Inc. is licensed in the State of Kansas and Minnesota as an insurance agency.

3. The Kansas Insurance Department and the Minnesota Department of Commerce have jurisdiction over this matter pursuant to K.S.A. 40-436(I) and Minn. Stat., § 45.027.
4. This action concerns the period from January 2001 through August 2002 (the "Relevant Period").

B. Background

5. Waddell & Reed, based in Overland Park, Kansas, has been a provider of financial services since 1937. It is owned by Waddell & Reed Financial, Inc., a publicly held company.
6. On December 31, 2002, the firm had 2,586 financial advisors, including 220 district managers and 70 district supervisors. Eight regional vice-presidents and 148 division and associate managers operated from 219 division and district sales offices located throughout the United States and managed the sales force. In addition, the firm had 182 individual advisor offices.
7. On December 31, 2001, the firm had 3,165 financial advisors, including 223 district managers and 102 district supervisors. Eight regional vice-presidents and 152 division and associate managers operated from 223 division and district sales offices located throughout the United States and managed the sales force. In addition, the firm had 199 individual advisor offices.
8. Waddell & Reed's business includes the sale of mutual funds, insurance products (through affiliated insurance agencies), variable annuities, variable life, and financial planning services. Customers can purchase investments in Waddell & Reed's mutual

funds directly or as the investment component of variable annuities underwritten by an insurance company and sold by Waddell & Reed.

9. Variable annuities have features of both securities and insurance products. The insurance part of the product is a guarantee of income for the life of the customer or the life of some other person designated by the customer, or for a specified period. The annuities also provide a death benefit, typically the greater of the contract value or net purchase payments. The amount of money placed into the variable annuity by the customer is invested in one or more subaccounts, which include mutual funds and money market accounts. The return received by variable annuity customers varies according to the performance of the subaccounts underlying the annuity. In this case, the subaccounts were created and managed by a Waddell & Reed affiliate.
10. The purchaser of an annuity through Waddell & Reed could decide in which Waddell & Reed mutual funds to invest the funds placed into the annuity. In the case of United Investors Life Insurance Company ("UILIC"), customers could choose from among a fixed account and eleven mutual fund and money market subaccounts offered by Waddell & Reed including a bond fund, international stocks, money market instruments, small-capital companies, and technology stocks. Customers could divide their funds among these funds. Waddell & Reed's financial advisors assist customers in evaluating the subaccount portfolios and allocating annuity monies among the portfolios. The value of these variable annuities will change over time, according to the performance of the subaccount portfolios into which the customer has placed her funds.

11. Most annuities, like those sold by Waddell & Reed, impose no front-end commissions purchase fees or sales charges added to the purchase price. They are, however, subject to the imposition of ongoing fees, assessed as a percentage of the money deposited into the annuity.
12. The UILIC Advantage II variable annuity had an 8.5% sales charge (paid on a deferred basis of 85 basis points per year for ten years), a .90% annual M&E fee, based on the current value of the investment, and a \$50 annual fee for the life of the investment. The UILIC Advantage Gold variable annuity has no front-end fee, a 1.40% annual M&E fee, based on the current value of the investment, and a \$25 annual fee for the life of the investment (waived for contracts over \$25,000).
13. The Waddell & Reed Advisors Select Annuity issued by Nationwide Life Insurance Company (NAIC #66869) (herein after "Nationwide") and Nationwide Life and Annuity Insurance Company (NAIC # 92657) (herein after "Nationwide"), had no front-end fee, a 1.35% annual M&E fee, and a \$30 annual administrative charge on policies valued at less than \$50,000. The Waddell & Reed Advisors Select Plus Annuity had no front-end fee and a .95% annual M&E fee.
14. All four of the variable annuities had Contingent Deferred Sales Charges ("CDSC"). A CDSC is an amount that must be paid upon the withdrawal from or exchange of the variable annuity if the withdrawal from or exchange occurs within a specified period of time. The amount is paid as a percentage of the money deposited into the annuity.
15. The UILIC Advantage II variable annuity carried a CDSC for the first eight years, declining 1% per year from 8% in the first year to 1% in the eighth year. The UILIC

Advantage Gold variable annuity had a CDSC for the first seven years, declining 1% per year from 7% in the first year to 1% in the final year. Each additional purchase payment carried a CDSC.

16. The CDSC for the Waddell & Reed Advisor's Select Annuity lasted for eight years and declined 1% per year from 8% in the first and second years to 2% in the eighth year. (This could be reduced to seven years at an additional cost of 5 basis points per year, based on current value.)
17. The CDSC for the Waddell & Reed Advisor's Select Plus Annuity lasted for seven years and declined 1% per year from 7% in the first and second years to 2% in the seventh year. (This could be reduced to five years at an additional cost of 15 basis points per year, based on current value.)
18. Waddell & Reed financial advisors who sold the variable annuities at issue received up-front commissions for each sale. Commissions on the products at issue ranged from 5-7.5%. The commission was paid by the insurance company to Waddell & Reed, which then paid part of the commission to the financial advisor. The commission paid to the financial advisor, however, did not come out of the principal amount invested by the customer in the annuity. Instead, the insurance company paid the commissions from its own funds and recouped that payment through the asset-based fees assessed each customer on an annual basis.
19. If a customer withdraws his or her funds from a variable annuity before the insurance company has recouped the commission it has paid to the sales agent, the insurance company might lose the money paid as commission to the financial advisor. To protect

against this, insurance companies commonly impose contingent deferred surrender charges (“CDSCs”) on annuity customers. If a customer withdraws his or her funds within the “surrender period” of an annuity, the customer must pay a surrender charge to the insurance company.

C. United Investors Variable Annuities

20. United Investors Life Insurance Company (“UILIC”) was founded by Waddell & Reed in 1961. Between 1961 and 2001, UILIC was the principal sponsor of the variable annuities sold by Waddell & Reed. In the 1980s, Waddell & Reed and UILIC were purchased by Torchmark, Inc. Both remained subsidiaries of Torchmark until November 1998, when Waddell & Reed was spun-off into a separate publicly-traded company. UILIC has remained a subsidiary of Torchmark.
21. Before Waddell & Reed was spun off by Torchmark, Waddell & Reed and UILIC entered into a Principal Underwriting Agreement and General Agency Contract. These agreements allowed Waddell & Reed to sell certain UILIC products and permitted Waddell & Reed’s registered representatives to act as authorized insurance financial advisors (producers) for UILIC. These agreements were renewed and amended periodically between 1998 and 2001.
22. Prior to 2000, the only UILIC variable annuity product offered through Waddell & Reed was called Advantage II. Advantage II is a deferred variable annuity policy issued by UILIC. Advantage II, through W&R Target Funds, offers the eleven mutual fund choices described above.

23. In 2000, Waddell & Reed began offering a new product created by UILIC, called Advantage Gold. Advantage Gold had more options and different features than the Advantage II. Advantage Gold, through W&R Target Funds, offered to policy owners the same eleven mutual fund choices that are offered by Advantage II.
24. UILIC charges its variable annuity customers various fees including annual fees and annual mortality and expense (M&E) charges (which are based on the size of the annuity).
25. In about 1999, Waddell & Reed requested that UILIC share with it a portion of the M&E charges that UILIC collected from Waddell & Reed customers. UILIC did agree to share 25 basis points of the M&E fees with Waddell & Reed on annuity products developed in the future, and 20 basis points of the M&E fees generated for existing products already held by customers. The parties later had a dispute as to whether the agreement was legally binding based on terms unrelated to compensation. This dispute resulted in a lawsuit filed by UILIC against Waddell & Reed in May 2000 in the state of Alabama.

D. Nationwide Annuities

26. In early 2000, based on the deteriorating relationship between Waddell & Reed and UILIC, Waddell & Reed began searching for variable annuity products issued by a different insurance company
27. Waddell & Reed began discussions with Nationwide around this time.
28. As part of this process, Waddell & Reed analyzed the potential profitability to the firm of switching the firm's variable annuity business from UILIC to another insurance company. Waddell & Reed's profitability projections assumed that 90% of its annuity customers

who would not have to pay surrender penalties would switch to annuities issued by a new insurance company. The company expected that between 20 and 65% of customers who would have to pay surrender charges would still agree to exchange their UILIC annuities for annuities issued by a new insurance company chosen by Waddell & Reed.

29. In October, 2000, Waddell & Reed finalized an agreement with Nationwide. Under this agreement, Nationwide created two new variable annuity products and agreed to let Waddell & Reed financial advisors sell insurance as agents for Nationwide. In December 2000, Waddell & Reed began selling Nationwide annuities alongside those of UILIC.
30. By March of 2001, Waddell & Reed was soliciting many of its customers to exchange their UILIC annuities for those issued by Nationwide.

E. Annuity Comparisons

31. Waddell & Reed worked with Nationwide to create products that would provide “the best opportunity for a clean case of 1035 [exchange of variable annuities].” Nationwide assisted in the design of products specifically for the purpose of replacement.
32. There were many similarities between Nationwide’s annuities and those of UILIC being exchanged.
 - A. The annuities from both Nationwide and UILIC were based on investment portfolios made up of Waddell & Reed mutual funds. The Nationwide annuities gave customers a choice of twelve mutual fund options and a fixed account option; eleven of the twelve mutual fund options were identical to the choices available with the UILIC policies. The additional portfolio option added for the Nationwide annuities was a “Value Portfolio.”

- B. They both provided death benefits for annuity customers, charged annual mortality and expense (M & E) fees, imposed CDSCs, and made available (sometimes at an extra charge) additional insurance benefits.
33. The Nationwide annuities did have some ways in which they differed from the UILIC annuities:
- A. The UILIC annuities did have an up-front 8.5% sales charge that was collected over a ten-year period. The Nationwide annuities had no sales charge.
- B. UILIC annuities imposed .90% of the annuity's value annually as M&E charges. The Nationwide Select annuity charged 1.35% annually while Select Plus charged customers .95% each year.
- C. The UILIC Advantage II annuities charged a \$50 annual policy fee. The Select annuities imposed a \$30 fee (waived when the contract value exceeded \$50,000); Select Plus products imposed no annual policy fee.
- D. The UILIC Advantage II annuity carried a CDSC for the first eight years, declining 1% per year from 8% in the first year to 1% in the eighth year. The UILIC Advantage Gold annuity had a CDSC for the first seven years, declining 1% per year from 7% in the first year to 1% in the final year. Each additional purchase payment carried a new CDSC.
- E. The CDSC for the Waddell & Reed Advisor's Select Annuity lasted for eight years and declined 1% per year from 8% in the first and second years to 2% in the eighth year. (This could be reduced to seven years at an additional cost of 5 basis points per year, based on current value.)

- F. The CDSC for Waddell & Reed Advisor's Select Plus Annuity lasted for seven years and declined 1% per year from 7% in the first and second years to 2% in the seventh year. (This could be reduced to five years at an additional cost of 15 basis points per year, based on current value.)
- G. The death benefit under the annuities generally was based on the size of the annuity. In some cases, due to the payment of surrender charges, customers may have had a smaller death benefit at Nationwide than with UILIC. The death benefit under the UILIC policies ratcheted up and locked in on the eight-year anniversary contract value and again on year sixteen, to whichever value was higher, although any step up of death benefits under the Advantage II that had been achieved disappeared if the policy holder lived past age 74.
- H. The Select Plus product has, as a standard feature, a "five-year reset" of death benefit, under which Nationwide paid the highest of (1) premiums paid (less any withdrawals), (2) the market value of subaccounts, or (3) the market value of the subaccounts on the most recent five-year anniversary of policy issuance before the policyholder's 86th birthday. This means that the value of the death benefit reset after five years could be reduced if the contract value of the annuity had dropped based on stock market performance during the preceding five years (but it would never be less than the net purchase value). Clients were able to take advantage of the last-occurring reset, even after age 86.
- I. There were variations on the insurance benefits available from each company. In some instances, insurance coverage for long-term confinement, disability, nursing

home expenses, and terminal illnesses were included as part of UILIC's Advantage Gold product, and to a lesser degree the Advantage II product, but were optional riders on the Nationwide policies.

34. Some of these differences benefited customers. Other differences were minor and may have created the appearance that they were giving added benefits to customers. Some of the differences were detrimental to customers who exchanged out of UILIC annuities and into Nationwide annuities.
35. In general, the differences meant that the UILIC products were more expensive at the outset, but the Nationwide products would become more expensive over time due to the higher M&E charges. The higher the value of the annuity, the more quickly the Nationwide products became more expensive than those from UILIC.

F. Extra Value Rider and the Select Annuity

36. One new feature offered with the Select Plus product was an extra value rider, or the so-called "bonus" feature. Customers who chose this feature would receive a 3% credit to their investment by purchasing a special rider. Customers choosing this 3% extra value rider feature were required to pay 45 basis points (.45%) of the annuity value per year for this feature. Training and compliance manuals for Waddell & Reed financial advisors emphasized that an annuity would have to reach a rate of return of at least 7.75% in order to pay for the cost of this extra value rider. Several of the mutual fund portfolios offered by Waddell & Reed were bond funds and money market funds; there was no reasonable expectation that they would achieve a 7.75% rate of return justifying the selection of this

extra value rider. In addition, this extra value rider was not suitable for investors intending to make additional purchase payments beyond the first year.

37. In almost all circumstances, the Select Plus Annuity had greater benefits and more flexibility to customers than the Select product. But, the Select product paid a higher commission to Waddell & Reed sales persons, 7.5% rather than 5%, and required customers to pay ongoing M&E charges 42% higher than the Select Plus product. Approximately 620 Waddell & Reed customers were moved into the Select product when they qualified for the Select Plus product.

G. Impacts of the Exchanges

38. Waddell & Reed benefited from the exchanges in two primary ways. First, the firm and its financial advisors earned a new commission on each annuity exchange. Second, Waddell & Reed began earning a 25 basis point fee from the M&E charges collected by Nationwide; one quarter of one percent of the value of all annuities moved to Nationwide was paid to Waddell & Reed annually.
39. Customers were put at risk of suffering several harms:
- A. Surrender Charges: At the urging of Waddell & Reed and its financial advisors, customers surrendered 6,742 UILIC annuities worth approximately \$616 million. Of these, 4,937 incurred surrender charges (73%) and 1,835 required no surrender charges. The total amount of surrender charges paid by customers to UILIC for these exchanges was \$9,667,266.
- B. M&E Charges: Select Plus customers paid higher ongoing M&E fees to Nationwide (.95% per year) than they had paid to UILIC (.90%) after the 10 year

holding period of 85 basis points sales charges. Customers having Select annuities paid annual charges equal to 1.35% of the value of their annuities.

- C. New CDSC: When the exchange was made, each customer became subject to a new surrender period of seven or eight years, depending on the annuity. This meant that a customer deciding to withdraw her funds from a Nationwide annuity before the surrender period had expired would have to pay a surrender charge when there might have been no surrender charge had the annuity remained at UILIC (or at least a reduced surrender charge due to the passage of time).
- D. Reduced Death Benefits: Customers exchanging their policies were at risk of recovering a lower benefit in the event of death during the term of the annuity. This could occur either of two ways. First, the value of a death benefit ordinarily was based on the value of funds in the annuity. Some customers who paid a surrender charge to UILIC transferred a lesser amount of money to Nationwide than the customer had at UILIC, resulting in a lower death benefit. Second, the UILIC policies gave customers the advantage of a greater death benefit if the value of the annuity was higher after eight years. The Nationwide policies provided that the death benefit could be lower if the stock market performance had reduced the value of the annuity on the "reset" dates.
- E. Extra Value Rider: Some customers purchased the so-called "bonus" rider, entitling the customer to a 3% credit to his first year's purchase payments bonus in income if the customer paid the annual .45% fee for the rider. But, many customers had funds in money market or bond funds that were paying and

expecting to pay considerably less than the 7.75% annual return needed to break even on the bonus. Others made additional purchase payments after the first year, raising the break-even point above 7.75%.

F. Other Riders: Many customers had the benefit of long-term confinement care, disability, nursing home, and terminal illness insurance benefits automatically under the UILIC products. However, those benefits were not always included in the Nationwide products, or required the payment of additional fees.

40. As a result of the potential disadvantages to customers, many of the customers who paid surrender charges as part of the annuity exchanges were likely to lose money or receive reduced benefits by making the switch.

H. Termination of Waddell & Reed/UILIC Relationship

41. In the first part of 2000, the relationship between Waddell & Reed and UILIC deteriorated sharply. In May 2000, UILIC initiated litigation against Waddell & Reed. As part of that litigation, UILIC issued subpoenas to some customers and financial advisors of Waddell & Reed who were involved in annuity exchanges. In February 2001, UILIC terminated its underwriting agreement with Waddell & Reed.

42. Beginning in January 2001, Waddell & Reed began an effort to contact customers regarding the UILIC dispute and recommend to its financial advisors and customers that they exchange their annuities with UILIC for one of the new Nationwide annuities. Various memoranda were issued to Waddell & Reed's financial advisors, recommending that they replace existing UILIC variable annuities with those from Nationwide:

- A. January 31, 2001: Waddell & Reed sent a memorandum to "All Field Personnel" saying, "UILIC is no longer interested in a constructive relationship with Waddell & Reed whereby you and your clients can receive the competitive products and services to which you are entitled."
- B. February 9, 2001: The company sent another memorandum to the Waddell & Reed sales force "to stress, again, that you should continue to use Nationwide products wherever appropriate." Advisors were told that "UILIC no longer appears to value a constructive, mutually supportive relationship with Waddell & Reed," but were not fully informed about the core dispute underlying the break with UILIC.
- C. February 15, 2001: Another memorandum said the advisors should be undeterred in recommending Nationwide products for clients, where it could be justified as appropriate and suitable.
- D. March 6, 2001: Waddell & Reed issued a memorandum to the sales force with a "Question and Answer" attachment. These materials informed financial advisors that the UILIC underwriting agreement would be terminated April 30, 2001.
- i. The memorandum warned that after termination of the underwriting agreement, UILIC "has the right to reassign variable annuity policies to non-Waddell & Reed representatives." Advisors were told that if this occurred, the trailing commissions being paid to the financial advisors would cease. Moreover, if a new financial advisor were assigned to the customers, there would be confusion for the customer and competition for

the customer's trust between the new financial advisor and the Waddell & Reed financial advisor.

- ii. The company stated doubts that "one might question [UILIC's] incentive to provide us a high level of service."
- iii. Financial advisors were told it "is very important that . . . you be especially proactive with your clients and take necessary steps to protect your relationships with them."
- iv. The company said a list of UILIC annuities in force would be sent to all supervisors so financial advisors could "utilize that information as appropriate in securing your client relationships."
- v. The memorandum noted that there could be no assurance that UILIC would continue to provide account information to the financial advisors.

E. March 13, 2001: Waddell & Reed held a conference call with its financial advisors. The company expressed concern that UILIC would provide customer's names to a competitor of Waddell & Reed. Company management stated outright, or inferred, sixteen different times on this call, that the financial advisors might lose their clients.

43. Some Waddell & Reed regional vice presidents (RVPs) began taking steps to encourage contacts with clients. One sent an e-mail to each of his division managers encouraging a "campaign of every advisor contacting every UILIC client" to explain what was happening with the UILIC relationship. Another told his division managers to have financial advisors set up meetings with all UILIC clients to "solidify our relationships."

A third RVP advised division managers and advisors that they need to "secure your client base, because that's their livelihood." A financial advisor reported to company officials that "the vast majority of clients are not wanting to stay with UILIC once they hear how they [UILIC] are cutting me off from servicing the accounts."

44. Waddell & Reed lacked a reasonable basis for many of the assertions in the March 6, 2001 memorandum and the conference call. The company did not know how the termination of the relationship with UILIC would affect Waddell & Reed's customers. The company had not sought information or assurances from UILIC regarding the concerns raised in the March 6 memorandum and the conference call.
45. As a result of these memoranda from the company, Waddell & Reed advisors began moving customers from UILIC to Nationwide annuities.
46. On March 14, 2001, the president of UILIC wrote a letter to Waddell & Reed assuring Waddell & Reed that UILIC would continue to provide compensation to Waddell & Reed advisors and would continue to provide service to both customers and financial advisors.
47. After receiving these assurances from UILIC, Waddell & Reed continued to encourage advisors to move clients away from their UILIC accounts. At this time, Waddell & Reed's president suggested that as the advisors discuss UILIC annuities with their clients, the advisors could indicate concern that UILIC's financial condition could deteriorate to the point it might cease being viable and that UILIC's employees might be demoralized, resulting in high turnover and inferior customer service.
48. On April 6, 2001, Waddell & Reed sent a memorandum to all division managers that included a list of UILIC policies for each financial advisor in the district, a question and

answer sheet, and a letter that could be sent to UILIC clients.

- A. The question and answer sheet gave little guidance to the advisor in determining the suitability of an exchange. However, it did list factors which could be taken into account in deciding whether to recommend an exchange. These factors included the client's desire to remain with the Waddell & Reed advisor and concern whether UILIC would service the annuity properly in the future. This document cast doubt on whether UILIC would live up to its commitment of continued service and raised the possibility that UILIC would close or fail as a result of severing its ties to Waddell & Reed.
- B. The letter to customers said while the UILIC annuities would continue in effect, the annuities might be reassigned to "another financial advisor from a company other than Waddell & Reed." The letter informed customers that their Waddell & Reed financial advisor would contact them to review their needs "and to determine what action, if any, we should take to ensure that [the customer's needs] continue to be met." Customers that received the letter believed that without the change, Waddell & Reed's financial advisors would not be able to service their accounts.

49. Waddell & Reed's efforts to promote these exchanges continued despite concern expressed by some financial advisors.

- A. Postings by financial advisors on an internal electronic bulletin board noted the absence of any substantive difference between the UILIC and Nationwide products and the lack of specific guidance to determine what exchanges were

appropriate.

- B. Some financial advisors expressed concern about increased regulatory scrutiny of annuity exchanges and urged other advisors to review the NASD suitability guidelines and the results of enforcement cases where other firms had been accused of churning customer accounts.
- C. An e-mail by one advisor to company management asked whether Waddell & Reed would mitigate the impact of surrender charges that will exceed 3% and whether the company would defend the financial advisors in litigation if the suitability of the exchange were challenged.
- D. Another financial advisor, recognizing that M&E charges, unlike the one-time sales charge, would continue through the life of the annuity and increase as the value of the investment portfolio increased commented: "I also have a family and retirement plans to support but I am having MAJOR problems costing my existing clients more over the long term to support these personal goals." This financial advisor complained to Waddell & Reed that for some customers, "the charges are too high to warrant switching to Nationwide."
- E. In June 2001, when Waddell & Reed's compliance manager said that retention of the advisor was, by itself, not sufficient to support an exchange recommendation, one supervisor complained "In my 17 years as a division manager, I have not experienced such a ridiculous request from a member of the compliance team."
- F. Some financial advisors complained of being pressured by their division managers and regional vice presidents to move clients, when the financial advisors did not

feel the exchanges would be suitable for the clients. The advisors were told that if they did not promote the exchanges, "the clients currently assigned to them will be reassigned."

50. Some Waddell & Reed financial advisors welcomed the opportunity to earn commissions with these exchanges. For example, the Select product paid a higher commission to the financial advisor than the Select Plus. One financial advisor, comparing commission payouts of the two products noted: "I have no problem selling an annuity that may cost .45 more on M/E charges because I have to support my family and pay my assistant and other business overhead."
51. On May 8, 2001, Waddell & Reed informed its financial advisors of UILIC's March 14 assurances that it would continue compensating Waddell & Reed financial advisors and would service customers and financial advisors.
52. On May 16, 2001, Waddell & Reed entered into a selling agreement with another financial services firm that, in turn, had an underwriting agreement with UILIC. This guaranteed the ability of Waddell & Reed advisors to continue servicing all remaining UILIC policies and to receive information about UILIC products. However, Waddell & Reed did not convey this information to its financial advisors until June 12. When this information became known among Waddell & Reed's financial advisors, the volume of annuity exchanges began to decline significantly. Around this time, Waddell & Reed also adopted a new "Variable Product Suitability Form" and required financial advisors to begin using it.

I. Waddell & Reed's Efforts to Exchange Annuities

53. In March 2001, the number of exchanges were 147, compared to 27 in February. In April, 711 annuities were exchanged. Another 1,600 exchanges occurred in May and June, a four-month total of over 2,500. By August 2002, 6,742 annuity products had been exchanged from UILIC to Nationwide. 4,937 customers paid surrender charges on these exchanges.

J. Suitability of the Exchanges

54. On January 12, 2001, Waddell & Reed adopted new suitability guidelines for variable annuity exchanges. These guidelines stated:

Advisors should be very careful when recommending that a client make a change of investment (i.e., switching from one variable product to another or switching from a non-variable investment to a variable product) in their portfolio. Because investment changes often result in new costs to a client, a client should be advised of any option to conduct a change without new or additional costs. Before recommending any change in a client's portfolio, it is imperative that the client understand all applicable expenses and fees involved in the change and any resulting tax consequences. All recommendations must be clearly in the best interests of the client and beyond reproach.

55. Waddell & Reed instructed its advisors that the exchanges should be suitable for customers. However, some of the company's conduct contributed to a failure to ensure that the transactions were suitable for the customers. These include overstating concerns that UILIC might assign different account representatives or would fail to service the accounts adequately, expressing doubt about the financial stability of UILIC, and unfairly comparing the features, costs, and effects on customers of the different annuity products.
56. Waddell & Reed and its advisors did not have adequate mechanisms for measuring or determining the cost and the potential long-term benefit or detriment of an exchange for

each customer, taking into account relevant objective factors, including age, sex, surrender charges, M&E expenses, policy features (including annuitization rates), and the costs and benefits of the particular optional policy features chosen by the customers.

In addition, Waddell & Reed had no specific guidelines or objective criteria by which advisors could determine whether a potential exchange would be suitable for individual clients or classes of clients.

57. As a result of the failure to provide adequate analytical tools or guidelines, Waddell & Reed advisors recommended variable annuity exchanges without having reasonable grounds for believing that the recommendations were suitable for customers based on their security holdings and their financial situations and needs.
58. From November 2000 until the spring of 2002, Waddell & Reed periodically revised its order processing, documentation, and review process for variable annuity exchanges. Until at least the spring of 2002, Waddell & Reed's supervisory system was deficient in that it failed to require analysis by division managers or other supervisors to determine the potential costs, benefits, and detriments to the customers of recommended exchanges.
59. In addition, the supervisory system did not include specific objective criteria or guidelines which advisors and division managers could apply to determine which categories or proposed exchanges were suitable or unsuitable, or required further review. Without this information, managers were not able to determine whether there was a reasonable basis for a recommended switch between the UILIC and Nationwide variable. In addition, the documentation initially required for approval of variable annuity switches by division managers did not include the reason for the exchange or the amount of surrender charge

to be paid.

60. Examples of unsuitable transactions included:

- A. The surrender charges were so significant for customers who had recently purchased UILIC products that a purchase of a substantially-similar Nationwide annuity could not reasonably be expected to result in a net benefit to the customers.
- B. Over 700 customers were moved from the UILIC Advantage II product to the Select product. The Select product was more expensive than the Select Plus and had fewer benefits overall. In those instances in which a Select policy had features not automatically included in the Select Plus product, those features could have been added as riders to the Select Plus product for a lower cost than purchasing the Select product. There were few, if any, circumstances in which a customer would be better off by buying the Select product rather than Select Plus.
- C. The extra value (bonus) rider was not suitable for customers intending to make additional purchase payments beyond the first year as the additional payments may negate any benefit of this rider.
- D. Some customers were sold a rider allowing annual withdrawals of an additional 5% of the investment amount without a surrender charge when any need for such a rider might indicate the annuity owner expected to withdraw funds before the expiration of the new surrender period.
- E. A significant number of policies were replaced for reasons that benefited the financial advisor, not the customer. These stated reasons for exchanges included

“cancellation of contract with Waddell & Reed,” “Able to service policy,”
“reassign the servicing of your policy to another financial advisor,” “change in
relationship with Waddell & Reed and United Investors,” “service by a senior
financial advisor with Waddell & Reed,” and “overall servicing of accounts.”

K. Dishonest or Unethical Practices

61. Some customers were persuaded to purchase a so-called “bonus” rider (actually, the extra value rider), for which the customers would pay an extra .45% of the value of their annuities each year. The prospectus for the Select Plus Annuity disclosed that this extra value rider could be advantageous only if the value of the mutual funds in the annuity were to rise more than 7.75% each year. While Waddell & Reed offered annuity customers a choice of twelve different mutual funds in which they could allocate their funds, some of the funds targeted safety of principal or income and were not expected to yield a 7.75% return. Customers who were persuaded to purchase the extra value rider, but whose investments were allocated into funds where the break-even point was not expected to be realized should not have been encouraged or permitted to purchase the extra value rider.
62. Of the 713 customers transferred into Nationwide’s Select products, 622 qualified for the Select Plus product. For these customers, the Select Plus product provided better features at lower costs to the customers. The customers should have been placed in the product that offered the best features at the lowest cost. Waddell & Reed financial advisors knew they would receive 7.5% commission on the amount of assets moved to the Select plan, whereas they would receive only 5% commission for customers placed in the Select Plus

product.

63. Some customers expressed the following to Waddell & Reed relating to the exchanges:
- A. One customer did not understand the amount he would have to pay in surrender charges. When asked why he had placed his initials on forms approving the exchange, one customer said: "I am 82 years old and I don't understand these things, we trust [financial advisor] to handle these things."
 - B. Another customer stated she would not have moved her annuity "if she were not forced" (emphasis in original).
 - C. "But, because I trust him [my advisor] so much, I just tell him to go ahead and do what needs to be done."
 - D. Another customer described the implicit trust she had in her advisor, saying: "It's like trusting your doctor. Or your minister."
 - E. "It was to my best interest. That's what he told me. . . . I trusted him"
 - F. "You know, the only reason that I changed was because I thought my money would earn more with this particular company and my financial advisor recommended it, suggested it. You know, I'm kind of one of those ignorant people that rely on financial advisors"

L. Failure to Perform Adequate Supervision

64. During the Relevant Period, Waddell & Reed's management failed to maintain and enforce adequate policies, procedures, and systems reasonably designed to prevent the recommendation and execution of unsuitable variable annuity exchanges and to ensure that its financial advisors provided full and accurate disclosures to customers and avoided

the use of dishonest or unethical practices.

M. NASD Settlements

65. Waddell & Reed consented to the entry of an order with the NASD in which Waddell & Reed agreed to pay a fine of \$5 million, restitution of up to \$11 million, and implementation of corrective action. Robert Hechler, former president of Waddell & Reed, consented to the entry of an order with the NASD in which he will be suspended from association with any NASD member in any capacity for six months and will pay a fine of \$150,000. Robert Williams, former national sales manager for Waddell & Reed, also agreed to pay a fine of \$150,000 and be suspended from association with any NASD member in a principal capacity for six months. Waddell & Reed, Hechler, and Williams neither admitted nor denied the allegations of the NASD Complaint.

II. CONCLUSIONS OF LAW

1. The Kansas Insurance Department and the Minnesota Department of Commerce have jurisdiction over this matter pursuant to the K.S.A. 40-436 and Minn. Stat. §§ 45.027 and 60A.031.
2. Waddell & Reed failed to ensure that recommendations that customers exchange variable annuities from UILIC to Nationwide were suitable for those customers, and or engaged in deceptive and misleading acts and/or practices, in violation of K.S.A. 40-2401 through 40-2406, K.S.A. 40-235, and K.A.R. 40-2-14 and Minn. Stat. § 60K.46, subd. 4.
3. Waddell & Reed engaged in dishonest or unethical practices in the exchange of customers' variable annuities from UILIC to Nationwide, in violation of K.S.A. 40-2404 (1) (a), (1)(d), and (1)(f), K.S.A. 40-235, and K.A.R. 40-2-14 and Minn. Stat. § 72A.20,

subd. 18 (b)

4. Waddell & Reed failed reasonably to supervise its financial advisors or employees, in violation of Minn. R. 2795.0800 and K.A.R. 40-2-14.
5. This Order is necessary and appropriate in the public interest and for the protection of customers and is consistent with the purposes fairly intended by the policy and provisions of Kansas and Minnesota law

III. ORDER

1. On the basis of the Findings of Fact, Conclusions of Law, and Respondent Waddell & Reed's consent to the entry of this Order, for the sole purpose of settling this matter prior to a hearing and without admitting or denying any of the Findings of Fact or Conclusions of Law,

IT IS HEREBY ORDERED:

2. This Order concludes the investigation by the Kansas Insurance Department and the Minnesota Department of Commerce and any other action that the Kansas Insurance Department could commence under the state insurance laws on behalf of the State of Kansas and the Minnesota Department of Commerce could commence under the state insurance and/or securities laws on behalf of the State Minnesota as it relates to Respondent Waddell & Reed, or any of its affiliates, and their current or former officers or directors arising from or relating to the recommendations and transactions by which variable annuities issued by UILIC and held by customers of Waddell & Reed were exchanged into Nationwide products; provided, however, that the Kansas Insurance Department and the Minnesota Department of Commerce may enforce any claims

against Respondent arising from or relating to any violation of the "Order" provisions herein.

3. This Consent Order shall become final upon its entry by the States of Kansas and Minnesota.
4. Waddell & Reed is censured for its conduct described in this Order.
5. As a result of the Findings of Fact and Conclusions of Law contained in this Order and the NASD Order, Waddell & Reed shall establish a fund in the amount of \$11 million, which fund shall be used to compensate customers as follows:
 - A. Payment of all surrender charges paid by such customers to UILIC for the exchange of Advantage II variable annuities to Nationwide variable annuities during the period January 2001 through August 2002; and
 - B. Payment to each customer who exchanged an Advantage II variable annuity for a Select variable annuity, who could have purchased a Select Plus variable annuity, in the amount of 2% of the value of the customer's Select annuity at the time of purchase. In the case of customers whose annuities have been terminated through death, lapsation, or otherwise, the amount paid shall be 25 basis points for each year that the policy was in effect.
6. Waddell & Reed shall, at its own expense, retain an independent consultant not unacceptable to the NASD and the States, to implement the distribution. Waddell & Reed shall cooperate fully with the consultant and shall not place restrictions on the consultant's communications with staff of the States of Kansas and Minnesota.
7. Consistent with the NASD Order settling the NASD disciplinary proceedings, Waddell &

Reed shall provide the consultant, the NASD, and the States with a proposed schedule of payments, setting out the customers to be compensated and the amount of compensation, and offsets for previous payments. If Waddell & Reed and the consultant are unable to agree as to any disputed payment amount, the determination of the consultant will be final.

8. Payments to customers pursuant to this section shall be paid by check and made no later than six months after the entry of this Order. Waddell & Reed and the consultant shall provide a final report of all payments to the NASD and the States, along with supporting documentation, including copies of checks or other evidence of payment requested by the States of Kansas or Minnesota. Money due to any customer who cannot be located shall be remitted to the escheat fund of the state of the customer's last known residence. After the consultant certifies that all compensation obligations have been fulfilled, the remaining amount in the fund, if any, shall be returned to Waddell & Reed.
9. Nothing in this Order shall preclude any customer from pursuing any other remedy to which the customer may be entitled.
10. Waddell & Reed shall identify all customers who had a decrease in minimum guaranteed death benefits resulting from an exchange of an Advantage II annuity for a Nationwide annuity. For customers who have died, after exchanging UILIC policies for Nationwide policies, Waddell & Reed already has paid the greater death benefit if the customer's death benefit was reduced by the exchange. Waddell & Reed shall continue to monitor those customer accounts in which the death benefit might be reduced and will pay the greater benefit to the customer. Within thirty days after this Order, Waddell & Reed will

- notify all customers who are in this situation of this right of reimbursement and will provide to representatives of the States' working group a copy of those notifications.
11. Waddell & Reed will continue to provide to the State all documents in its custody and control and make available appropriate witnesses under its control for any further investigations of exchange activity involving variable annuities involving any entity or person other than Waddell & Reed and its current and former officers and directors.
 12. Waddell & Reed shall provide all information reasonably necessary to the states of Kansas or Minnesota to demonstrate the company's compliance with the terms of this Order.
 13. The amount of restitution required by this Order to be paid by Waddell & Reed to its customers shall not exceed \$11 million. Waddell & Reed has already provided compensation to customers who purchased the 3% Extra Value Rider ("bonus rider") where the policyholder's portfolio allocation would not be expected to yield the investment return necessary to recoup the cost of the rider. In addition, the company has committed to addressing additional instances in which annuity exchanges were not suitable or where other remediation would be appropriate. Any such additional payments shall be in circumstances or under guidelines established by Waddell & Reed and shall not require approval or notice to the States of Kansas or Minnesota.
 14. Waddell & Reed shall pay an amount of at least \$145,291.70 to Kansas and \$68,110.85 to Minnesota as a civil monetary penalty which amount constitutes the states of Kansas or Minnesota's proportionate share of the state settlement amount of Two Million Dollars (\$2,000,000). This amount shall be paid to the states within ten days of the entry of this

- Order. Any amounts of this \$2 million penalty for the states that remains on October 31, 2005, based on any states deciding not to join the multistate settlement in this matter, will be allocated proportionately among the states participating in this settlement (based on the number of exchanges in each state) and paid to these states by December 31, 2005.
15. If Waddell & Reed enters into a settlement with any state securities or insurance enforcement agency that is not generally consistent with the multistate settlement proposed ("non-joining state") relating to the matters described in this Order, for an amount greater than the amount the non-joining state would have received under the multistate settlement, Waddell & Reed shall pay the states joining the settlement an amount sufficient to cause those states which joined the settlement the same proportionate recovery as paid to the non-joining state.
 16. If payment is not made by Waddell & Reed as required by this Order, the Kansas Insurance Department and the Minnesota Department of Commerce may vacate this Order, at their sole discretion, upon ten days notice to Waddell & Reed and without opportunity for administrative hearing and Waddell & Reed agrees that any statute of limitations applicable to the subject of the investigation and any claims arising from or relating thereto are tolled from and after the date of this Order until such date that the Kansas Insurance Department and the Minnesota Department of Commerce vacate this Order.
 17. This Order is not intended by the Kansas Insurance Department and the Minnesota Department of Commerce to subject any Covered Person to any disqualifications under the law of the United States, any state, the District of Columbia or Puerto Rico, including,

without limitation, any disqualifications from relying upon the state or federal registration exemptions or safe harbor provisions. "Covered Person" means Waddell & Reed or any of its affiliates or their current or former officers, directors, employees, or other persons that otherwise would be disqualified as a result of the Orders (as defined below).

18. This Order and the order of any other State in related proceedings against Waddell & Reed (collectively, the "Orders") shall not disqualify any Covered Person from any business that he or she otherwise is qualified, licensed, or permitted to perform under applicable laws of the States of Kansas or Minnesota and any disqualifications from relying upon this States registration exemptions or safe harbor provisions that arise from the Orders are hereby waived.
19. For any person or entity not a party to this Order, this Order does not limit or create any private rights or remedies against Waddell & Reed including, without limitation, the use of any e-mails or other documents of Waddell & Reed or of others regarding variable annuity exchanges or limit or create liability of Waddell & Reed or limit or create defenses of Waddell & Reed to any claims.
20. This Order and any dispute related thereto shall be construed and enforced in accordance, and governed by, the laws of the States of Kansas or Minnesota, without regard to any choice of law principles.
21. Waddell & Reed agrees not to take any action or to make or permit to be made any public statement denying, directly or indirectly, any finding in this Order or creating the impression that this Order is without factual basis. Nothing in this Paragraph affects Waddell & Reed's (i) testimonial obligations or (ii) right to take legal or factual positions

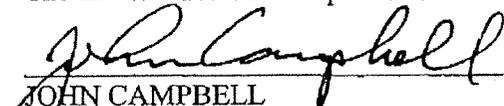
in defense of litigation or in defense of a claim or other legal proceeding in which the Kansas Insurance Department and the Minnesota Department of Commerce is not a party.

- 22. Waddell & Reed, through its execution of this Consent Order, voluntarily waives its right to a hearing on this matter and to judicial review of this Order under K.S.A. 77-501 et. seq., the Kansas Administrative Procedures Act and/or K.S.A. 77-601 et., seq., The Act for Judicial Review and Civil Enforcement of Agency Actions and Minn. Stat. §§ 45.027 and 60K.43.

DATED this 10th day of June, 2005.

SANDY PRAEGER
 Commissioner
 The Kansas Insurance Department

By:



 JOHN CAMPBELL
 General Counsel



 GLENN WILSON
 Commissioner
 Minnesota Department of Commerce

**CONSENT TO ENTRY OF ORDER BY
WADDELL & REED, INC.**

1. Waddell & Reed and its attorneys hereby acknowledge that they have been served with a copy of this Order, and have read the foregoing Order, and are aware of its right to a hearing and appeal in this matter, and have waived the same.
2. Waddell & Reed admits the jurisdiction of the Kansas Insurance Department and the Minnesota Department of Commerce neither admits nor denies the Findings of Fact and Conclusions of Law contained in the Order, and consents to entry of this Order by the Kansas Insurance Department and the Minnesota Department of Commerce as settlement of the issues contained in this Order.
3. Waddell & Reed states that no promise of any kind or nature whatsoever was made to it to induce it to enter into this Order and that it has entered into this Order voluntarily.
4. Thomas W. Butch represents that he/she is Chairman of the Board and President of Waddell & Reed and that, as such, has been authorized by Waddell & Reed to enter into this Order for and on behalf of Waddell & Reed.
5. Waddell & Reed understands that the states of Kansas or Minnesota may make such public announcement concerning this Order and the subject matter thereof as the states may deem appropriate.

DATED this 10th day of June, 2005.

WADDELL & REED, INC.

By: Thomas B. [Signature]

Title: Chairman of the Board and President

SUBSCRIBED AND SWORN TO before me this 10th day of June, 2005.

Julia A. Brown
Notary Public

My Commission Expires: 3/16/09



NASD
OFFICE OF HEARING OFFICERS

<hr/>		
DEPARTMENT OF ENFORCEMENT,	:	
	:	
Complainant,	:	
	:	
v.	:	Disciplinary Proceeding
	:	No. CAF040002
WADDELL & REED, INC. (BD #866),	:	
ROBERT HECHLER (CRD #800216),	:	
ROBERT WILLIAMS (CRD #468213), and	:	Hearing Officer -- AP
	:	
Respondents.	:	
<hr/>		

**ORDER ACCEPTING OFFERS OF SETTLEMENT
BY RESPONDENTS WADDELL & REED, INC.,
ROBERT HECHLER, AND ROBERT WILLIAMS**

INTRODUCTION

Disciplinary Proceeding No. CAF040002 was filed on January 14, 2004, by the Department of Enforcement of NASD ("Complainant"). Respondents Waddell & Reed, Inc., Robert Hechler, and Robert Williams submitted Offers of Settlement ("Offers") to Complainant on April 28, 2005. Pursuant to Code of Procedure Rule 9270(e), the Complainant and the National Adjudicatory Council ("NAC") Review Subcommittee or the Office of Disciplinary Affairs ("ODA") have accepted the uncontested Offers. Accordingly, this Order now is issued pursuant to Code of Procedure Rule 9270(e)(3). The findings, conclusions and sanctions set forth in this Order are those stated in the Offer as accepted by the Complainant and approved by the NAC.

Under the terms of the Offer, Respondents have consented, without admitting or denying the allegations of the Complaint, 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, to the entry of findings and violations consistent with the allegations of the Complaint, and to the imposition of the sanctions set forth below, and fully understands that this Order will become part of Respondents' permanent disciplinary records and may be considered in any future actions brought by NASD.

FINDINGS AND CONCLUSIONS

It has been determined that the Offer be accepted and that findings be made consistent with allegations of the Complaint, which is attached hereto and incorporated herein by reference.

Based on the foregoing, as described in the Complaint, Respondent Waddell & Reed violated NASD Conduct Rules 2110, 2310, 3010, and 3110; Section 17(a)(1) of the Securities Exchange Act of 1934 and Rule 17a-3(a)(6) thereunder; Respondent Robert Hechler violated NASD Conduct Rule 2110; and Respondent Robert Williams violated NASD Conduct Rules 2110 and 3010.

Based on these considerations, the sanctions hereby imposed by the acceptance of the Offer are in the public interest, are sufficiently remedial to deter Respondents from any

future misconduct, and represent a proper discharge by NASD of its regulatory responsibility under the Securities Exchange Act of 1934.¹

SANCTIONS

It is ordered that the following sanctions be, and hereby are, imposed:

Waddell & Reed, Inc.:

1. A censure.
2. A fine of \$5 million paid to NASD within thirty days of the entry of this Order.
3. Establishment by Waddell & Reed of a fund in the amount of \$11 million, which fund shall be used to compensate customers as follows:²
 - (a) payment of all surrender charges paid by such customers to United Investors Life Insurance Company for the exchange of Advantage II variable annuities to Nationwide variable annuities during the period January 2001 through August 2002; and

¹ In assessing this fine, NASD has taken into account Waddell & Reed's agreement to pay an additional \$2 million to state regulatory agencies in connection with the conduct underlying this matter. Waddell & Reed has also agreed to establish the fund described herein in connection with its settlement agreement with those agencies.

² All payments shall be reduced by any amount previously repaid to the customer, as demonstrated by Waddell & Reed to the consultant and the Department of Enforcement. In order to demonstrate that any such payment has been made, Waddell & Reed shall provide proof of payment, and any supporting documentation, to the consultant, with copies provided to the Department of Enforcement.

(b) payment to each customer who exchanged an Advantage II variable annuity for a Select variable annuity, who could have purchased a Select Plus variable annuity, in the amount of 2% of the value of the customer's Select annuity at the time of purchase.³

4. Waddell & Reed shall, at its own expense, retain an independent consultant not unacceptable to NASD to implement the distribution. Waddell & Reed shall cooperate fully with the consultant and shall not place restrictions on the consultant's communications with NASD staff. For a period of two years following the date of the conclusion of the independent consultant's work as described herein, neither Waddell & Reed, nor any of its principals, agents, officers, directors or employees acting in their capacities as such, may employ or otherwise hire the independent consultant in any capacity. Any firm with which the independent consultant is affiliated or of which he or she is a member, and any person or firm engaged to assist the consultant in the performance of his or her duties shall not, without prior written consent of Department of Enforcement staff, enter into any employment, consulting or other professional relationship with Waddell & Reed, or any of its directors, officers, employees, or agents in their capacity as such for the period of the engagement and for a period of two years thereafter.

³ However, in the case of customers whose annuities have been terminated, through death, lapsation, or otherwise, the payment shall not exceed 25 basis points for each year that the policy was in effect.

5. Within thirty days of the entry of this Order, Waddell & Reed shall provide the consultant and the Department of Enforcement with a proposed schedule of payments, setting out the customers to be compensated and the amount of compensation, and offsets for previous payments. If Waddell & Reed and the consultant are unable to agree as to any disputed payment amount, the determination of the consultant will be final.
6. Payments to customers pursuant to this section shall be paid by check and made no later than six months after the entry of this Order. Waddell & Reed and the consultant shall provide a final report of all payments to the Department of Enforcement, along with supporting documentation, including copies of checks or other evidence of payment. Money due to any customer who cannot be located shall be remitted to the escheat fund of the state of the customer's last known residence. After the consultant certifies that all compensation obligations have been fulfilled, the remaining amount in the fund, if any, shall be returned to Waddell & Reed.
7. Nothing in this Order shall preclude any customer from pursuing any other remedy to which the customer may be entitled.

Robert Hechler:

1. A six-month suspension from association with any NASD member in any capacity.
2. A fine of \$150,000.

Robert Williams:

- 1. A six-month suspension from association with any NASD member in a principal capacity.
- 2. A fine of \$150,000.

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

SO ORDERED.

Dated: _____, 2005

NASD

By: _____
 [Name]
 [Title], Department of Enforcement
 on behalf of the Director of ODA, pursuant
 to delegated authority

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	:	
	:	
Complainant,	:	
	:	
v.	:	Disciplinary Proceeding
	:	No. CAF040002
WADDELL & REED, INC. (BD #866),	:	
ROBERT HECHLER (CRD #800216),	:	
ROBERT WILLIAMS (CRD #468213), and	:	Hearing Officer --
	:	
Respondents.	:	

Note for electronic delivery this complaint:
The issuance of a disciplinary complaint represents the initiation of a formal proceeding by NASD Regulation in which findings as to the allegations in the complaint have not been made and does not represent a decision as to any of the allegations contained in the complaint. Because this complaint is unadjudicated, you may wish to contact the respondent before drawing any conclusions regarding the allegations in the complaint.

COMPLAINT

Upon information and belief, the Department of Enforcement alleges as follows:

SUMMARY

1. During the period from January 2001 to August 2002, Respondent Waddell & Reed, Inc. ("W&R") engaged in an aggressive effort to switch the variable annuity investments of its customers from those provided by one insurance company to very similar annuities provided by another insurance company. As a result of those efforts, W&R registered representatives recommended, and W&R exchanged, more than 6,700 variable annuities worth approximately \$616 million. Those exchanges generated more than \$37 million in commissions to W&R, and cost its customers approximately \$9.8 million in surrender charges.

2. W&R failed to take adequate steps to ascertain whether there were reasonable grounds for the customers to enter into these exchanges. It failed to perform a sufficient analysis to determine whether the customers were likely to benefit or lose money from the exchanges and failed to establish sufficient guidance for the sales force or management to use in determining the suitability of the exchanges. As a result, W&R and its registered representatives did not have a reasonable basis for the recommended exchanges and the exchanges violated NASD's suitability rule.
3. In many of the more than 6,700 switches recommended and effected by W&R, the customers were likely to lose money by making the switch.
4. W&R failed to establish and maintain supervisory procedures, or a system to supervise the activities of its advisors, that was reasonably designed to achieve compliance with the requirements of NASD's suitability rule.
5. Robert Hechler was the President of W&R during the period relevant to this matter. Hechler actively encouraged W&R's sales force to engage in the switching activity, despite W&R's lack of adequate procedures to supervise and review the exchanges. As a result, Hechler caused violations of NASD's suitability rule.
6. Robert Williams was W&R's National Sales Manager during the period relevant to this matter. Williams was responsible for ensuring that the exchange transactions were appropriately reviewed by W&R managers for compliance with suitability requirements, and for ensuring the firm and its registered personnel complied with Conduct Rule 2310. Williams failed to supervise W&R managers in a manner reasonably designed to achieve compliance with the requirements of the suitability rule.

7. By virtue of this conduct, W&R violated Conduct Rules 2110, 2310, and 3010, Hechler violated Conduct Rule 2110 by causing violations of Rule 2310, and Williams violated Conduct Rules 2110 and 3010.

RESPONDENTS

8. **Waddell & Reed, Inc.**, is a member firm based in Overland Park, Kansas. It has more than 3,300 registered personnel in 417 branches, and has been an NASD member since 1939. Its business includes the sale of mutual funds, insurance products, variable annuities, variable life, and financial planning services. It is owned by Waddell & Reed Financial, Inc., a publicly-traded company (NYSE: WDR). The firm's registered representatives, called financial advisors, report to approximately 150 first-level supervisors, called division managers, who in turn report to eight regional vice presidents. A significant portion of W&R's business is derived from the sale of its own mutual fund products. The mutual funds are available as separate products or as subaccounts of variable annuities sold by W&R in conjunction with an insurance company.
9. **Robert Hechler** was the President, Chief Executive Officer and Chief Financial Officer of W&R from 1993 until the end of 2001, and was the Executive Vice President and Chief Operating Officer of the parent company during that period. He is now retired, but remains registered as a general securities representative, general securities principal, and financial and operations principal with Waddell & Reed. He has held all of those licenses with W&R (or its affiliates) since entering the securities industry in 1974.
10. **Robert Williams** has been W&R's Executive Vice President and National Sales Director since July 1996, when he first joined W&R. Prior to joining W&R, he was registered with four other firms, starting in 1984. Williams is registered as a general securities representative

and general securities principal. As National Sales Director, Williams had supervisory authority over the regional vice presidents, the division managers, and the registered representatives. He had ultimate responsibility for ensuring that transactions were appropriately reviewed for suitability.

FACTS UNDERLYING THE VIOLATIONS

Background

11. Until the events at issue in this case, the principal sponsor of the variable annuities sold by W&R was United Investors Life Insurance Company ("UILIC"). UILIC was founded by W&R in 1961. Both were purchased by Torchmark, Inc. in the 1980s, and remained wholly-owned subsidiaries of Torchmark until November 1998, when W&R was spun-off into a separate, publicly-traded company. UILIC remains a subsidiary of Torchmark. Prior to the spin-off of W&R, W&R and UILIC entered into a Principal Underwriting Agreement and General Agency Contract allowing W&R to sell certain UILIC products. After the spin-off, the various agreements between W&R and UILIC were periodically renewed and amended.
12. The primary UILIC variable annuity product offered through W&R was the Advantage II. In 2000, W&R began to offer a new product created by UILIC, called the Advantage Gold, which had significantly more options and different features than the Advantage II.
13. In or about 1999, W&R sought to have UILIC share a portion of the annual mortality and expense ("M&E") charges UILIC collected from variable annuity policy holders who had purchased through W&R. W&R sought 25 basis points ("b.p.") on both existing assets under management as well as new sales. Although UILIC and W&R reached an agreement on M&E sharing, which was set forth in a letter, the parties later had a dispute as to whether it

was legally binding as it had never been reduced to a formal contract. This dispute resulted in a lawsuit between the parties in the state of Alabama.

14. In early 2000 W&R began to search for a variable annuity provider to either complement or replace UILIC. By the summer of 2000, W&R was analyzing the possibility of switching at least some of its UILIC business to a new product. As a part of this analysis, Hechler created a spreadsheet analyzing the potential profitability of switching the firm's UILIC variable annuity business to another provider, based on M&E fees. His spreadsheet assumed that there would be exchanges by 90% of customers who held annuities with no remaining surrender charge, and exchanges by 20 – 65% of customers who had held variable annuities for five to eight years and thus would need to pay surrender charges to make an exchange.
15. W&R chose Nationwide Insurance Co. as its new annuity provider in or about the summer of 2000. W&R thereafter worked with Nationwide to develop the products they would offer. The agreement between W&R and Nationwide was finalized in October 2000, and W&R began selling Nationwide products in December 2000, alongside those of UILIC.

Introduction of New Nationwide Products

16. Nationwide provided two variable products, called the Select and Select Plus. The underlying investment portfolios of the Nationwide products were almost identical to those in the UILIC products offered through W&R. Both the Nationwide and the UILIC variable annuities offered the same eleven W&R mutual funds; the Nationwide products offered one additional fund. The Nationwide products also had a number of insurance features not available in the Advantage II. These features were offered either as optional riders (for an annual fee measured as a percent of the value of the account each year) or as part of the product itself.

17. The UILIC Advantage II had a 8.5% front-end fee (paid on a deferred basis of 85 b.p. per year for 10 years), a .90% annual M&E fee, based on the current value of the investment, and a \$50 annual fee for the life of the investment. The Nationwide Select had no front-end fee, a 1.35% annual M&E fee, and a \$30 annual fee on policies valued at less than \$50,000. The Nationwide Select Plus had no front-end fee and a .95% annual M&E fee. Thus, among the products, the Advantage II was the most expensive at the outset, but the Nationwide products would become more expensive over time because of the higher ongoing M&E fees.
18. Both the Advantage II and the Select had Contingent Deferred Sales Charges ("CDSC"). A Contingent Deferred Sales Charge is an amount which must be paid upon the sale or exchange of the variable annuity if the sale or exchange occurs within a specified period of time. The amount is paid as a percentage of the premium paid.
19. The UILIC Advantage II carried a CDSC for the first eight years, declining 1% per year from 8% in the first year to 1% in the eighth year. The CDSC for the Nationwide Select lasted for eight years and declined 1% per year from 8% in the first and second years to 2% in the seventh year. The CDSC for the Nationwide Select Plus lasted for seven years and declined 1% per year from 7% in the first and second years to 2% in the seventh year.
20. The Nationwide Select Plus was the only one of the products to offer a bonus feature: a 3% bonus, at cost of 45 b.p. per year for 7 years. The annuity would have to reach a rate of return of at least 7.75% in order to pay for the cost of the bonus feature.
21. Exchanges of variable annuities by W&R customers were potentially costly to the customers in a number of ways. Customers who switched before the end of the CDSC period paid surrender charges, and all customers who switched incurred a new CDSC with the new product and could not sell the product during the CDSC period without paying the surrender

charge. In addition, W&R customers who switched into the Nationwide variable annuities paid higher ongoing M&E fees than they had been charged with the UILIC products.

22. W&R, on the other hand, made money in a number of ways by having its customers switch from UILIC to Nationwide variable annuities. First, the firm and the advisors made a commission on each exchange. Second, Nationwide paid W&R a fee of 25 b.p. annually from the M&E fee paid by W&R customers. UILIC, by contrast, did not share any portion of the M&E fee on existing Advantage II assets with W&R. Third, by exchanging customers into the Nationwide products, W&R eliminated the risk of decreasing the assets under W&R's management, which could have occurred if UILIC replaced or supplemented the W&R mutual funds with funds offered by other companies.

Termination of the W&R/UILIC Relationship and Management's Encouragement of Switching

23. In early 2001, the relationship between W&R and UILIC deteriorated severely. UILIC notified W&R it was terminating its underwriting agreement or PUA. Later, in May 2001, UILIC and W&R became involved in litigation in Alabama state court over the terms of their business relationship. After the switching began, UILIC issued subpoenas arising from that litigation to some W&R advisors and customers who had been involved in exchanges.
24. Beginning in early 2001, Hechler and others at W&R engaged in an aggressive effort to encourage W&R's sales force to replace UILIC variable annuities with Nationwide variable annuities. Hechler issued a series of memoranda to the sales force repeatedly encouraging them to replace existing UILIC variable annuities with Nationwide variable annuities.
25. For instance, in a January 31, 2001 memorandum, Hechler stated that UILIC's issuance of subpoenas "suggests that UILIC is no longer interested in a constructive relationship with Waddell & Reed, whereby you and your clients can receive the competitive products and

services to which you and they are entitled.” The memorandum stated Hechler’s confidence in the firm’s compliance procedures and encouraged switches “whenever appropriate and suitable.”

26. On February 9, 2001, Hechler sent a memorandum to the sales force stating that he wanted “to stress, again, that you should continue to use Nationwide products wherever appropriate. . . This is especially important since UILIC no longer appears to value a constructive, mutually supportive relationship with Waddell & Reed.”
27. On February 15, 2001, Hechler sent another memorandum reassuring the sales force of his confidence in the firm’s compliance procedures. He also reiterated that the field should be undeterred in using Nationwide products for clients where appropriate and suitable.
28. On March 6, 2001, Hechler sent a memorandum and “Question and Answer” attachment to the sales force advising them that UILIC was terminating the Principal Underwriting Agreement (under which W&R was selling UILIC’s products), effective April 30, 2001, and encouraging them to exchange UILIC variable annuities for Nationwide variable annuities. In the memorandum and Question and Answer attachment, Hechler made assertions about UILIC’s intentions which would reasonably be expected to, and did, lead W&R’s sales force to aggressively seek to replace UILIC products.
29. For instance, Hechler’s March 6, 2001 memorandum stated that “one might question [UILIC’s] incentive for seeking to provide us a high level of service”; questioned whether “UILIC’s variable and other business will receive meaningful attention or resources going forward”; and stated:

Third, and perhaps most important from your perspective, once UILIC has terminated the Principal Underwriting Agreement, it has the right to reassign variable annuity policies to non-Waddell & Reed representatives

and to make [other] mutual funds ... available to clients. It is reasonable to expect these actions by UILIC, one outcome of which would be to cut off the flow of policy information to Waddell & Reed advisors. It therefore is very important that, in the time between now and April 30, you be especially proactive with your clients and take necessary steps to protect your relationships with them. To support that effort, divisions soon will receive a list of UILIC policies sold and serviced by advisors within that division. We urge you to utilize this information as appropriate in securing your client relationships. (Emphasis in original).

30. Hechler's March 6 memorandum also claimed that UILIC could replace W&R's underlying mutual funds with other mutual funds, in which case the advisors' trailing commissions would cease. The accompanying Question and Answer attachment raised questions about UILIC's servicing of client accounts, offering reasons why, despite UILIC's obligation to provide service, "there is no assurance that accounts will continue to be serviced appropriately." The attachment also suggested that UILIC would assign an unaffiliated advisor to the W&R clients, which "has an enormous potential to confuse our clients and set up a competition for their policy between the existing Waddell & Reed advisor and the newly named representative." In addition, the attachment stated that "there can be no assurance that UILIC will endeavor to continue to provide account information to our advisors, perhaps leaving them cut off from information regarding their clients' accounts."

31. During the week following Hechler's March 6 memorandum, W&R held a conference call with its sales force. During this call, Hechler, Williams, and others again encouraged the sales force to seek to replace UILIC policies with Nationwide policies. Williams solicited questions from the field in advance of the conference call. More than one person raised the need to waive or pay back CDSCs, or to extend the current CDSC period, in connection with proposed exchanges. However, this issue was not addressed during the call.

32. During the conference call, one member of W&R management told the sales force that UILIC might reassign its policies to other representatives, which would result in the introduction of "another person . . . into your relationship with your client." Hechler told the sales force that UILIC would probably provide customers' names to a competitor of W&R. Hechler also said that W&R would be sending advisors lists of clients with UILIC products. One member of W&R management addressed a question from the sales force about whether they could "migrate products to Nationwide more aggressively" by stating "if your client understands the situation and understands the economics of the transaction, it is ultimately their decision to make."
33. In response to another question during the conference call about the possible development of clearer internal standards to govern exchanges, one member of W&R management stated "[it] would not be practical to develop rigid standards because there will always be cases where there are reasonable exceptions." Another questioner suggested that W&R create a grid to assist advisors in analyzing the costs and benefits of proposed exchanges. A member of W&R management responded that the company would look into it.
34. Hechler did not have a reasonable basis for many of the assertions in his March 6, 2001 memorandum. He did not know how the termination of the relationship with UILIC would affect W&R's customers, and neither he nor others at W&R had sought information or assurances from UILIC regarding the various concerns that he raised. There similarly was no adequate basis for many of the statements made during the conference call about the effect of the termination of the relationship with UILIC.
35. In response to the pressure from senior management, some W&R regional vice presidents (RVPs) began taking steps to encourage exchanges. One RVP sent an e-mail to his division

managers on March 6 encouraging a "campaign of every advisor contacting every UILIC client" to explain what was happening with the UILIC relationship. He later set up a "Call-a-Thon" for advisors in his region to call all of their customers with UILIC VAs. On March 7, another RVP sent an e-mail to his division managers advisors to contact UILIC clients. He wrote that it was "imperative that we solidify our relationships with our clients. We need to put in place a process of setting up individual meetings with all UILIC clients." A third RVP advised division managers and advisors that they "need to go out and secure your client base, because that's their livelihood. . . . Review all their accounts and . . . continue to have the good relationship so nobody else can get in the door on us."

36. On March 21, 2001, a week after receiving the letter from UILIC, Hechler sent an e-mail to W&R's Chief Marketing Officer with "some notes and ideas that might be used in communications with the sales force that could be used by Advisors as they work with their clients." Some of these "ideas" were that UILIC's financial condition could deteriorate to the point that it would no longer be viable as a separate company, and that UILIC's employees could be demoralized to the extent that turnover would be high, which in turn could have a detrimental effect on the level and quality of policyholder service. Hechler also noted in his e-mail that, since UILIC's original purpose was to provide insurance products for Waddell & Reed's mutual fund shareholders, clients could be told that "with the recent action of terminating its arrangement with Waddell & Reed, its primary distributor, it may be a good time to review your insurance needs to determine if more attractive alternatives are available."
37. On April 6, 2001, Williams and W&R's Chief Marketing Officer sent a memo to all division managers that included a list of all UILIC policies for each advisor in the district, an approved

letter for clients, and a Q&A sheet. The Q&A sheet contained many points taken from Hechler's March 21, 2001 e-mail to the Chief Marketing Officer, as described above. The letter told customers that the policies might be reassigned but that the lawsuit with UILIC did not affect their UILIC policies. It also stated that clients, in deciding whether to switch, could make the determination based on whether the benefits of the new policy, retention of service and desire to keep the advisor outweighed the costs of an exchange. The Q&A sheet gave no guidance to assist an advisor in determining the suitability of an exchange. It did, however, list the client's desire to remain with the W&R advisor, and concerns about whether UILIC would service the policy properly in the future, as factors which could be taken into account in deciding whether to recommend an exchange. The Q&A also contained statements casting doubt on whether UILIC would live up to its commitment of continued service, and raised the possibility that UILIC would close or fail as a result of severing ties to W&R.

38. Following these events, the number of switches from UILIC variable annuities to Nationwide variable annuities began to increase dramatically. Between March 1, 2001 and the end of June 2001, W&R engaged in over 2500 switches from UILIC to Nationwide variable annuities, involving assets of approximately \$269 million, surrender charges of \$4.7 million, and commissions of \$16.1 million. During the month of March 2001, the number of switches from UILIC policies to Nationwide policies jumped 540% over the previous month from 27 to 145. In April, the number of switches jumped another 490% over March's total from 145 to 711, and ranged from 451 to 819 per month for following six months.
39. A number of postings by advisors on W&R's internal bulletin board during March and April of 2001 reflect the concerns of the sales force about the suitability of the proposed exchanges, as well as the belief by advisors that they were being encouraged to promote exchanges.

These postings noted W&R's push to protect or secure client relationships, as well as the absence of any substantive difference between the UILIC and Nationwide products and the lack of specific guidance to determine what was appropriate. As one advisor noted in a posting following the conference call:

the comments were scripted in large part to prod and scare advisors into moving dollars from UILIC annuities to Nationwide annuities. . . . There is absolutely no suitable reason I can think of to move dollars from a UILIC annuity to a Nationwide annuity. . . . I suggest any advisor considering 1035 exchanging dollars review the NASD suitability guidelines and look at cases where other firms and their advisors have been accused and fined for churning.

Even as late as July 2001, one advisor noted in a posting: "It is clear the company would like all monies out of United Investors control as soon as possible."

40. In a letter dated March 14, 2001, as the switching activity was beginning to occur, the president of UILIC assured Hechler that UILIC would continue to provide compensation to W&R advisors and would continue to provide service to both W&R policyholders and advisors. Despite learning this information and knowing its importance to the sales force, and despite having repeatedly made statements questioning whether this would occur, neither Hechler nor anyone else at W&R relayed this information to W&R's sales force until May 8, 2001.
41. On May 16, 2001, W&R entered into a Limited Selling Agreement with another firm, which in turn had an agreement with UILIC. The Limited Selling Agreement guaranteed the ability of W&R advisors to continuing servicing all remaining UILIC policies and to receive information about those. Again, despite the importance of this information to the sales force, particularly in light of statements Hechler and others had repeatedly made questioning

whether it would occur, W&R's advisors were not notified of this agreement until June 12, 2001. Once they were advised, the volume of exchanges began to decline significantly.

42. By August of 2002, W&R, through the recommendations of its advisors, had replaced 6,772 Advantage II variable annuities issued by UILIC. Those replacements transferred approximately \$617 million in assets away from UILIC, cost customers more than \$9.8 million in surrender charges, and generated approximately \$37 million in commissions to W&R. Additionally, W&R earned approximately \$700,000 from M&E fee sharing arrangements with Nationwide in 2001, and W&R will continue to accrue such fees annually. Approximately 66% of W&R's 2001 Nationwide variable annuities sales came from replacements of existing Advantage II policies.

43. W&R management was kept informed of the large numbers of switches that occurred. Summary reports showing the volume of exchange activity were sent to Williams and, in the later part of 2001, to Hechler, as well to senior management in the marketing, sales management, and compliance departments. These reports showed the volume and dollar amount of new and 1035 variable annuity business, and identified the top producers and divisions. An internal analysis prepared in July 2001 showed that approximately 58% of W&R's \$493 million in annuity sales in the first half of 2001 represented exchanges from UILIC.

FIRST CAUSE OF ACTION

**VIOLATION OF NASD CONDUCT RULES 2310 AND 2110 BY
WADDELL & REED**

44. The allegations of paragraphs 8 through 43 are repeated and realleged herein.

45. Despite repeated requests from division managers and advisors, W&R failed to provide its advisors with adequate guidance, analytical tools, or criteria for making the critical suitability analysis required for recommending variable annuity exchanges.
46. In particular, W&R and its advisors did not have adequate mechanisms for measuring or determining the cost and the potential long-term benefit or detriment of an exchange for each customer, taking into account relevant objective factors, including age, sex, surrender charges, M&E expenses, policy features (including annuitization rates), and the costs and benefits of the particular optional policy features chosen by the customers. In addition, W&R had no specific guidelines or objective criteria by which advisors could determine whether a potential exchange would be suitable for individual clients or classes of clients.
47. As a result of the failure to provide adequate analytical tools or guidelines, W&R advisors recommended variable annuity exchanges without having reasonable grounds for believing that the recommendations were suitable for the customers based on their security holdings and their financial situations and needs.
48. Many of the exchanges were in fact unsuitable. Under one analysis, more than 1400 of the exchanges were likely to result in the customers' losing money.
49. In at least eighteen instances, W&R customers, at the recommendation of W&R and its advisors, exchanged Advantage Gold annuities for Nationwide annuities. These exchanges were unsuitable because the products were substantially identical, and the Advantage Gold product was so new that exchanges resulted in a surrender charge of at least 5%, which could not be justified by any features of the Nationwide product.
50. In addition, W&R exchanged 713 customers from the Advantage II policy to the Select policy. There were few, if any, circumstances, however, in which a client should have

purchased the Select rather than the Select Plus. The Select was more expensive than the Select Plus, and had fewer benefits. Those features of the Select which were not included in the Select Plus could have been added as riders to the Select Plus without bringing the cost up to the same level as the Select. The Select Plus had features or options which were not included or available in the Select, even as riders, and by adding certain riders to the Select Plus, a client could obtain all of the features of the Select, plus have the added features and flexibility of the Select Plus, at the same cost.

51. However, the Select did provide a higher payout to the advisors, one of whom, in comparing the payouts, noted "I have no problem selling an annuity that may cost .45 more on M/E charges because I have to support my family and pay my assistant and other business overhead." Another advisor replied by noting that M&E costs, unlike sales charges, would continue throughout the life of the annuity, and increase as the value of the portfolio grows. That advisor concluded "I also have a family and retirement plans to support but I am having MAJOR problems costing my existing clients more over the long term to support these personal goals."
52. The only basis for recommending the Select over the Select Plus was its lower minimum investment amount of \$2,000 (compared to \$15,000 for the Select Plus). Of the 713 customers who were exchanged into the Select, only 91 initially invested more than \$2,000 but less than \$15,000. There was no reasonable basis for the remaining 622 recommended exchanges into the Select.
53. By failing to obtain a reasonable basis for the recommended switches from UILIC to Nationwide policies, and by recommending and effecting switches in which customers were likely to lose money, W&R violated NASD Conduct Rules 2310 and 2110.

SECOND CAUSE OF ACTION

VIOLATION OF CONDUCT RULE 2110 BY HECHLER

54. The allegations of paragraphs 8 through 53 are repeated and realleged herein.
55. Hechler took a number of actions to persuade W&R's sales force to switch customers from UILIC variable annuities to Nationwide variable annuities. These included numerous statements to W&R's sales force to encourage them to aggressively engage in switching activity.
56. Hechler was informed on an ongoing basis in the later part of 2001 of the large numbers of switches that were being made from UILIC to Nationwide variable annuities.
57. Hechler did not have a reasonable basis for many of the statements he made to encourage the switches. Moreover, once he became aware that certain of his statements were incorrect, he failed to act in a timely manner to inform the sales force of the accurate information. During the period he failed to act, W&R's sales force continued to make switches on the basis of the inaccurate information he had provided.
58. Despite his efforts to encourage aggressive switching activity, Hechler failed to take adequate steps to ensure, in light of the large-scale switching activity that was to occur, that W&R had procedures reasonably designed to achieve compliance with NASD's suitability rule.
59. By virtue of the foregoing, Hechler caused violations of Conduct Rule 2310 and thereby violated Conduct Rule 2110.

THIRD CAUSE OF ACTION

**FAILURE TO SUPERVISE: VIOLATION OF NASD CONDUCT
RULES 2110 AND 3010 BY WADDELL & REED**

60. The allegations of paragraphs 8 through 53 are repeated and realleged herein.

61. From November of 2000 until the spring of 2002, W&R periodically revised its order processing, documentation, and review process for variable annuity exchanges. Until at least the spring of 2002, W&R's supervisory system was deficient in that it failed to require sufficient analysis by division managers or other supervisors to determine the potential costs, benefits, and detriments to the customers of recommended exchanges.
62. In addition, the supervisory system did not include specific, objective criteria or guidelines which advisors and division managers could apply to determine which categories of proposed exchanges were suitable or unsuitable, or required further review. Without this information, managers were not able to determine whether there was a reasonable basis for a recommended switch between the UILIC and Nationwide variable annuities. In addition, the documentation initially required for approval of variable annuity switches by division managers did not include the reason for the exchange or the amount of surrender charge to be paid.
63. Throughout this time period, division managers and or financial advisors raised their inability to conduct an adequate review of the proposed switches from UILIC to Nationwide variable annuities, and the lack of objective suitability guidelines or criteria for such switches, with members of W&R senior management, including Williams and Hechler.
64. By virtue of the foregoing, W&R failed to establish and maintain a supervisory system reasonably designed to achieve compliance with NASD Conduct Rule 2310, in violation of NASD Conduct Rules 3010(a) and 2110.

FOURTH CAUSE OF ACTION

**FAILURE TO SUPERVISE: VIOLATION OF NASD CONDUCT
RULES 2110 AND 3010 BY WILLIAMS**

65. The allegations of paragraphs 8 through 53 are repeated and realleged herein.
66. As National Sales Director, Williams had supervisory authority over the regional vice-presidents, the division managers, and the registered representatives, and had ultimate responsibility for ensuring that transactions are appropriately reviewed for suitability.
67. Williams knew of and was involved in the effort to aggressively encourage W&R advisors to switch customers from UILIC to Nationwide variable annuities. He also knew of and was informed on an ongoing basis of the large numbers of switches that were being made from UILIC to Nationwide variable annuities.
68. Williams knew that there were problems with W&R's process for reviewing the suitability of switches from UILIC to Nationwide variable annuities. For instance, as early as January 2001, an RVP told Williams in an e-mail that the compliance process in regard to suitability was not organized or easy to follow, and that too much compliance responsibility was being placed on division managers and advisors. In March of 2001, one of W&R's top producers told Williams in an e-mail that certain advisors felt they needed assistance in evaluating suitable 1035 exchange activity, asking for "examples of what would be a situation (i.e. amount of surrender charges incurred to leave UILIC policies) that is in your view reasonable and defensible and what situations you see as unreasonable and we have to advise the client to leave their funds with UILIC....."
69. Williams was aware of instances where inappropriate switches were made so that customers could retain their advisors. He also received e-mails demonstrating that the sales force felt pressure to make switches because of the fear that UILIC would reassign policies to non-W&R representatives.

70. Williams was aware that the division managers did not have adequate criteria, analytical tools or substantive guidelines to review the exchanges which he and others were aggressively promoting. For instance, two regional vice presidents copied Williams on e-mails in which they requested the development or circulation of an internal spreadsheet for managers to use in reviewing exchanges. Williams also knew that W&R's advisors needed and were asking for analytic or other tools to assist them in evaluating the costs and benefits of the exchanges.
71. Williams knew or should have known that W&R advisors did not have the necessary tools to make appropriate suitability determinations and that W&R division managers did not have the necessary tools to perform the review of those determinations required by the firm's procedures.
72. Williams failed to take reasonable action to supervise the firm's activities in switching customers from UILIC variable annuities to Nationwide variable annuities.
73. By virtue of this conduct, Williams violated NASD Conduct Rules 3010 and 2110.

FIFTH CAUSE OF ACTION

**FAILURE TO MAINTAIN BOOKS AND RECORDS REGARDING
ORDERS FOR UNEXECUTED VARIABLE ANNUITY EXCHANGES:
VIOLATION OF NASD CONDUCT RULES 2110 AND 3010 BY
WADDELL & REED**

74. The allegations of paragraphs 8 through 53 are repeated and realleged herein.
75. Under Section 17(a)(1) of the Securities Exchange Act of 1934 and Rule 17a-3(a)(6) thereunder, broker-dealers must make and keep certain specified records, including a "memorandum of each brokerage order, and of any other instruction, given or received for the purchase or sale of securities, whether executed or unexecuted." Under Conduct Rule

3110, NASD members must make and preserve books, records, and memoranda in conformity with Rule 17a-3.

76. W&R did not maintain, and did not require division offices to maintain, copies of customer orders for variable annuity exchanges which were submitted by an advisor but rejected by the division manager. By failing to maintain such records, W&R failed to comply with the requirement of Rule 17a-3(a)(6) to create and keep a memorandum of unexecuted orders.
77. By this conduct, W&R violated Section 17(a)(1) of the Securities Exchange Act of 1934, Rule 17a-3(a)(6), and NASD Conduct Rules 2110 and 3110.

PRAYER FOR RELIEF

WHEREFORE, the Complainant respectfully requests:

- A. Findings of fact and conclusions of law that Respondents committed the violations charged and alleged herein;
- B. An order imposing fitting sanctions upon Respondents in accordance with NASD Procedural Rule 8310, including but not limited to disgorgement of the commissions generated on the exchanges, restitution of the loss to customers, and a fine;
- C. An order imposing such costs of any proceeding as are deemed fair and appropriate under the circumstances in accordance with NASD Procedural Rule 8330; and
- D. An order imposing any other appropriate sanction.

Dated: January 14, 2004

Department of Enforcement
NASD
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Washington, DC 20006-1500
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by: Roger Sherman, Esq., Senior Vice President
Thomas Lawson, Esq. Chief Counsel
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Of Counsel:
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Department of Enforcement
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IN THE MATTER OF THE *
 MULTI-STATE EXAMINATION OF * CONSENT ORDER
 WADDELL & REED INC *
 W & R INSURANCE AGENCY INC *
 {ENTITY NAME IN STATE} *

* * * * *

This Consent Order is hereby issued by the _____ Department of Insurance (the "Department") in disposition of the matter captioned above.

FINDINGS OF FACT

1. Respondent W & R Insurance Agency Inc., hereinafter "Waddell & Reed", is a licensed insurance agency in the state of {_____} at {_____}.
2. The States of Kansas and Minnesota (the "Lead States") coordinated a multi-state investigation of the Respondent with regard to variable annuity sales practices in connection with Respondent encouraging existing customers who held variable annuity products to surrender the products and to purchase similar products issued by a different insurer. The Lead States participated in and coordinated the negotiation and finalization of the regulatory settlement between Respondent and the states participating therein.
3. As a result of the investigation the Lead States alleged that the Respondent's variable annuity sales practices were in violation of the insurance laws of the Lead states. The Respondent neither admits nor denies the allegations.
4. Respondent is licensed to engage in the business of insurance in this state. As affecting this state, the {Department} has jurisdiction over the subject matter of this proceeding and Respondent.
5. A proposed settlement has been presented to the Department, the terms of which are set forth in Consent KS Consent Order 3468-CO and MN Consent Order _____ (the "Kansas and Minnesota Consent Order") dated June ___, 2005, which has been executed by Respondent, the Kansas Insurance Department, and the Minnesota Department of Commerce, in their capacity as two of the primary negotiators, a copy of which is attached hereto as Exhibit A.

- 6. Upon review of the Consent Order, it is found that it is a fair and proper disposition of the matters addressed therein.

ORDER

WHEREAS it is stipulated and agreed upon by and between the Department and Respondent and **ORDERED** as follows:

- A. The Consent Order dated June ____, 2005, attached hereto as Exhibit A, incorporated herein by reference, adopted fully, and is hereby approved.
- B. Respondent shall immediately initiate compliance with all terms and conditions of the as incorporated herein.

IN WITNESS WHEREOF, the Department and Respondent have executed this Consent Order.

Consented to in form and content:

WADDELL & REED INC.
(NAME OF INSURANCE AGENCY)

DEPARTMENT OF INSURANCE

BY: _____
Signature

BY: _____

Name

Name

Title

Title

WADDELL & REED STATE BY STATE EXCHANGES									
<u>This list contains the number of variable annuity exchanges in each state.</u>									
<u>The two million dollar fine will be distributed as follows:</u>									
<u>\$20,000 to each state and the District of Columbia = \$1,020,000</u>									
<u>Each state will receive \$145.35 for each exchange made in that state = \$979,949.70</u>									
<u>Total number of exchanges = 6,742</u>									
				Total					Total
AK	49	7,122.15	20,000	27,122.15	MT	155	22,529.25	20,000	44,529.25
AL	3	436.05	20,000	20,436.05	NC	38	5,523.30	20,000	25,523.30
AR	12	1,744.20	20,000	21,744.20	ND	15	2,180.25	20,000	22,180.25
AZ	81	11,773.35	20,000	31,773.35	NE	168	24,418.80	20,000	44,418.80
CA	917	133,285.95	20,000	153,285.95	NH	62	9,011.70	20,000	29,011.70
CO	315	45,785.25	20,000	65,785.25	NJ	19	2,761.65	20,000	22,761.65
CT	11	1,598.85	20,000	21,598.85	NM	84	12,209.40	20,000	32,209.40
DC	4	581.40	20,000	20,581.40	NV	48	6,976.80	20,000	26,976.80
DE	3	436.05	20,000	20,436.05	NY	2	290.70	20,000	20,290.70
FL	95	13,808.25	20,000	33,808.25	OH	24	3,488.40	20,000	23,488.40
GA	53	7,703.55	20,000	27,703.55	OK	106	15,407.10	20,000	35,407.10
HI	12	1,744.20	20,000	21,744.20	OR	400	58,140.00	20,000	78,140.00
IA	62	9,011.70	20,000	29,011.70	PA	154	22,383.90	20,000	44,383.90
ID	211	30,668.85	20,000	50,668.85	RI	18	2,616.30	20,000	22,616.30
IL	476	69,186.60	20,000	89,186.60	SC	36	5,232.60	20,000	25,232.60
IN	151	21,947.85	20,000	41,947.85	SD	136	19,767.60	20,000	39,767.60
KS	862	125,291.70	20,000	145,291.70	TN	22	3,197.70	20,000	23,197.70
KY	44	6,395.40	20,000	26,395.40	TX	234	34,011.90	20,000	54,011.90
LA	1	145.35	20,000	20,145.35	UT	104	15,116.40	20,000	35,116.40
MA	60	8,721	20,000	28,721.00	VA	21	3,052.35	20,000	23,052.35
MD	2	290.70	20,000	20,290.70	VT	1	145.35	20,000	20,145.35
ME	0	0.00	20,000	20,000.00	WA	517	75,145.95	20,000	95,145.95
MI	107	15,552.45	20,000	35,552.45	WI	177	25,726.95	20,000	45,726.95
MN	331	48,110.85	20,000	68,110.85	WV	4	581.40	20,000	20,581.40
MO	259	37,645.65	20,000	57,645.65	WY	75	10,901.25	20,000	30,901.25
MS	1	145.35	20,000	20,145.35					
TOTALS						979,949.70	1,020,000	1,999,949.70	