

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 05-98

November 9, 2005

DAVID A. NOYES & CO., INC.
MEMBER ORGANIZATION

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Recommended and sold variable annuities to customers that were unsuitable; violated Exchange Rule 405(1) by failing to use due diligence to learn essential facts relative to customers in connection with the sale of variable annuities; violated Exchange Rule 405(2) by failing to diligently supervise accounts handled by registered representatives in connection with the sale of variable annuities; and violated Exchange Rule 342 in that it (a) failed to reasonably supervise and control certain of its business activities concerning the sale of variable annuities; and (b) failed to reasonably supervise and control the activities of a producing Branch Office Manager in connection with his activities as a registered representative - Consent to censure, a total payment to the Exchange of \$550,000, and an undertaking and customer restitution procedures.

Appearances:

For the Division of Enforcement
Steven F. Korostoff, Esq.
Danielle I. Schanz, Esq.
Howard L. Kneller, Esq.

For the Respondent
Matthew D. Parrott, Esq.
Jonathan Feld, Esq.

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A Hearing Panel of the New York Stock Exchange, Inc. ("Exchange") met to consider a Stipulation of Facts and Consent to Penalty entered into between the Exchange's Division of Enforcement ("Enforcement") and David A. Noyes & Co., Inc. ("Respondent Firm"), a member organization. Without admitting or denying guilt, Respondent Firm consented to a finding by the Hearing Panel that it:

- I. Engaged in conduct inconsistent with just and equitable principles of trade in that it recommended and sold variable annuities to customers that were unsuitable.
- II. Violated Exchange Rule 405(1) by failing to use due diligence to learn essential facts relative to customers in connection with the sale of variable annuities.
- III. Violated Exchange Rule 405(2) by failing to diligently supervise accounts handled by registered representatives in connection with the sale of variable annuities.

- IV. Violated Exchange Rule 342 in that it (a) failed to reasonably supervise and control certain of its business activities concerning the sale of variable annuities; and (b) failed to reasonably supervise and control the activities of a producing Branch Office Manager in connection with his activities as a registered representative.

For the sole purpose of settling this disciplinary proceeding, Enforcement and Respondent Firm stipulate to certain facts, the substance of which follows:

Background and Jurisdiction

1. Respondent Firm was established in 1908 and became a member organization of the Exchange in 1927. It currently has principal offices located in Chicago, Illinois and Indianapolis, Indiana, as well as seven branch offices located in Illinois, Indiana, Ohio and Michigan.
2. In May of 2001, the Exchange commenced a Special Examination of Respondent Firm (the "Special Examination"). In an examination report dated December 28, 2001 (the "Special Examination Report"), the Exchange's Division of Member Firm Regulation ("MFR") determined, among other things, that improper annuity switches, i.e., the purchase of an annuity with the proceeds of the sale of an existing annuity, were occurring at a branch of the firm located in Wausau, Wisconsin (the "Branch") and that Respondent Firm was inadequately supervising such switches.
3. By letter dated May 2, 2002, Respondent Firm was notified that the Exchange had commenced an investigation concerning annuities sales and supervision based on certain of the exceptions contained in the Special Examination Report.
4. Thereafter, Respondent Firm responded and certain of its employees and officers provided information and testimony in connection with the Exchange's investigation.

Summary

5. During the period October 1999 through December 2001 (the "Relevant Period"), Respondent Firm violated Exchange Rules in that, among other things, it (a) executed approximately 125 variable annuity switches on behalf of customers, the majority of which were unsuitable, and (b) improperly supervised such switches. This conduct occurred despite the fact that during such period Respondent Firm was censured and fined by the Exchange for improperly supervising annuity sales and was notified of improper annuity switches by the Securities and Exchange Commission ("SEC") and an employee of Respondent Firm. In addition, during the Relevant Period, Respondent Firm failed to reasonably supervise and control the activities of a producing Branch Office Manager in connection with his activities as a registered representative.

Annuity Sales

Introduction

6. Beginning when the Branch was opened in 1996, Respondent Firm, through its registered representatives at the Branch, recommended, sold and granted supervisory approval for the execution of variable annuity switches on behalf of customers.
7. Many annuities, including those sold at the Branch, have substantial “surrender” fees that are assessed if the purchaser of the annuity decides to “cash in” the investment within a number of years after they are purchased. Such fees often constitute seven to eight percent of the investment principal if the annuity is redeemed during the first year after it is purchased. Thereafter, such fees often decrease by one percent per year.
8. As a result of, among other things, the aforementioned surrender fees, annuities are generally viewed as long-term investments.
9. During the Relevant Period, approximately 125 annuity switches were executed at the Branch.

Regulatory History and the Adoption by the Respondent of Written Policies Concerning Annuity Sales

10. In January 1998, MFR conducted an examination of Respondent Firm. In a report issued to Respondent Firm in March of that year, MFR concluded that there were a large number of annuity switches at the Branch that had substantial surrender charges and that Respondent Firm violated Exchange Rule 342 by, among other things, failing to have appropriate written procedures relating to such annuity switches.
11. A 1998 SEC examination of Respondent Firm resulted in a letter being sent to Respondent Firm by the SEC concerning Respondent Firm’s lack of certain written procedures governing annuity switches, as well as an uncorrected exception from a prior examination by the National Association of Securities Dealers (“NASD”) that related to the fact that BOM, the producing Branch Office Manager of the Branch, was not reviewing customer annuity applications submitted by other registered representatives in the Branch.
12. Thereafter, a number of the issues raised by MFR’s 1998 examination were referred to Enforcement for investigation.
13. Following such investigation, Enforcement and Respondent Firm agreed to settle the aforementioned matter. On or about September 22, 1999, on consent, an Exchange Hearing Panel found that Respondent Firm violated Exchange Rule 342 by failing to, among other things:

- A. Maintain written procedures relating to the sale and supervision of annuities as well as the review of its annuity business for use during branch office audits.
 - B. Maintain procedures to monitor the number or frequency of annuity switches.
 - C. Prevent its registered representatives from effectuating annuity switches without supervisory review for completeness, accuracy and suitability.
 - D. Maintain a master list of annuity switches, thus allowing for the creation of exception reports by which to monitor whether an excessive number of switches were occurring.
14. In connection with the foregoing disciplinary action, the Hearing Panel imposed, among other things, a censure, a fine of \$60,000 and an undertaking relating to certain other matters in the case. (Decision 99-132 N.Y.S.E. Hearing Panel September 22, 1999)
15. In March of 2000, in response to the aforementioned Exchange disciplinary action, Respondent Firm created certain written procedures regarding annuity switches (the "March 2000 Procedures").
16. The March 2000 Procedures mandate the following multi-part approval process with respect to variable annuity switches that are effectuated at Respondent Firm:
- A. First, all annuity switches have to be approved by a Branch Office Manager before they are submitted to the issuing company.
 - B. Second, where the surrender charge of an annuities contract (1) exceeds \$5,000, or (2) is three percent or more of the investment principal, the transaction has to be further approved prior to submission to the issuing company, by the Firm's National Insurance Manager or National Sales Manager.
 - C. Third, if any funds are withdrawn within the first two years, and are to be reinvested, further approval as set forth above is required.
17. On or about February 16, 2001, the SEC sent a letter to Respondent Firm following an examination of their books and records. The SEC stated in this letter that improper annuity switches were continuing and that Respondent Firm was not adequately supervising such switches. The SEC also stated in this letter that many customer files at the Branch did not contain information concerning customers sufficient to assess whether the annuity switches at issue were suitable.
18. In February 2001, MFR and the NASD conducted a joint examination of Respondent Firm's compliance with financial and operational requirements. In a report issued on

April 2, 2001, MFR found, among other things, that Respondent Firm violated Exchange Rule 342 by failing to adhere to its own annuity approval process.

19. In May of 2001, the Exchange commenced the Special Examination of Respondent Firm. As set forth above, the Special Examination Report indicated, among other things, that improper annuity switches were occurring at the Branch and that Respondent Firm was inadequately supervising such switches.

Unsuitable Annuity Switches and Supervisory Violations

20. BOM, as the former Branch Office Manager of the Branch, was responsible for submitting approval request forms for annuity switches as required under the March 2000 Procedures.
21. While acting in his supervisory capacity, BOM failed to submit requests for the approval of annuity switches as required under the March 2000 Procedures. Moreover, BOM acted to intentionally evade the requirements of the March 2000 Procedures so as to cause annuity switches to be effectuated at the Branch that were not subject to appropriate supervisory review.
22. For example, during the period April 1, 2000 through December 31, 2001, there were at least 73 annuity switches that required approval of the National Insurance Manager or National Sales Manager under such procedures. BOM only requested approvals in approximately six of these transactions. Also in violation of such procedures, the six approvals that were requested were not made prior to the time that the transactions were submitted to the issuing company.
23. Moreover, many of the annuity switches that occurred at the Branch during the Relevant Period were switches of original annuity contracts that had been held for only a few years or less, thus causing the customers involved to incur substantial surrender fees, other charges and increased expenses in connection with such transactions.
24. In connection with such annuity switches, certain registered representatives at the Branch often advised their customers that the surrender fees, charges and expenses at issue would be offset by, among other things, (a) sign-up bonuses that were given by the issuer of the new annuities upon execution of the switches, and (b) the fact that the new annuities contained features (i.e., a lock-in or “step-up” of the customer’s guaranteed death benefit) not found in the annuities that were being replaced.
25. Contrary to the aforementioned representations, however, the imposition of the aforementioned surrender fees, charges and increased expenses rendered the majority of the approximately 125 annuity switches that were executed at the Branch during the relevant Period to be financially disadvantageous to the customers involved. Accordingly, the majority of such switches were unsuitable.

26. In addition, Respondent Firm, through certain of its registered representatives at the Branch, failed to use due diligence to learn the essential facts relative to customers in connection with the effectuation of the aforementioned annuities switches.
27. Instead, Respondent Firm, through certain of its registered representatives at the Branch, systematically engaged in annuity switches on behalf of certain of its customers during the Relevant Period without regard to the customers' individual circumstances, such as the time period in which such customers required access to the invested funds, the amount of time since their purchase of the previous annuity and the amount of life insurance that they already had.
28. As set forth above, Respondent Firm failed to establish an adequate system of follow-up and review to ensure that the March 2000 Procedures were being followed and that only suitable annuities switches were executed at the Branch. The majority of the annuity switches that were executed at the Branch during the Relevant Period were therefore not subject to adequate supervisory review by Respondent Firm.

**Notice of Unsuitable Annuity Switches From Firm Staff
In Addition to Aforementioned Notice by Regulators**

29. At all relevant times, IM was Respondent Firm's National Insurance Manager, PF was the President of Respondent Firm, a member of Respondent Firm's Board of Directors and a principal of Respondent Firm, and Robert Cram ("Cram") (Decision 05-94 N.Y.S.E. Hearing Panel August 24, 2005) was Respondent Firm's Director of Compliance and General Counsel.
30. Prior to and subsequent to the adoption of the March 2000 Procedures, IM sent certain memoranda to members of Respondent Firm's senior management, including in certain instances PF and Cram, complaining in substance that annuity switches were being executed that were not in the best interests of the customers involved. Certain of the memoranda sent by IM subsequent to the adoption of the March 2000 Procedures further complained in substance that IM was not receiving approval requests from the Branch that were required under the March 2000 Procedures.
31. Prior to the adoption of the March 2000 Procedures and during 2001, IM spoke with PF, Cram and other members of Respondent Firm's senior management concerning annuity sales at Respondent Firm. During certain of these discussions, IM advised the aforementioned individuals about his concerns as set forth above.
32. The aforementioned communications by IM to Respondent Firm's senior management, as well as the aforementioned findings by regulators, constituted notice to Respondent Firm that unsuitable and improperly supervised annuity switches were occurring at the Branch. Nonetheless, Respondent Firm failed to take steps that were reasonably calculated to prevent such conduct from continuing.

The Supervision of BOM

33. As set forth above, BOM was a producing BOM. As such, Respondent Firm had an obligation to review his work as a registered representative, including his trades, new account documentation, correspondence, account designation changes and error reports on a periodic and regular basis rather than allow BOM to be self-supervised.
34. During the period that he was employed by Respondent Firm, BOM's work as a registered representative was not subject to adequate supervisory review.
35. Had BOM's work as a registered representative been adequately supervised, Respondent Firm may have been able to take steps to prevent the violative conduct committed by him, including his recommendation, approval and execution of unsuitable annuity switches as set forth above.
36. In addition, during the Relevant Period, the Branch was comprised of less than eight registered representatives, including BOM, his three brothers and their father. As a result, BOM was responsible for supervising four registered representatives who were members of his immediate family.
37. At a minimum, Respondent Firm had an obligation to impose a system of heightened supervisory controls and procedures with respect to the review of BOM's supervision of such individuals.
38. Despite the foregoing, Respondent Firm failed to impose such system of heightened supervisory controls and procedures.
39. Based upon the above, Respondent Firm failed to reasonably supervise and control the activities of BOM in connection with both his activities as a registered representative and the Branch Office Manager of the Branch.

DECISION

The Hearing Panel, in accepting the Stipulation of Facts and Consent to Penalty, found Respondent Firm guilty as set forth above by unanimous vote.

PENALTY

The Stipulation of Facts and Consent to Penalty here addresses 125 mostly unsuitable variable annuity switches on behalf of customers and the improper supervision of such switches. Respondent Firm had been previously disciplined by the Exchange for improperly supervising annuity sales.

The Exchange relies on four precedents to support its penalty, only one of which includes variable annuities. In re Waddell & Reed, Inc., (NASD Office of Hearing Officer, April 29, 2005) involved the respondent recommending almost 7,000 variable annuity exchanges to its customers without determining suitability. The respondent was required to pay \$11 million to more than 5,000 customers, pay a fine of \$5 million to the NASD and \$2 million to State Regulators.

In re A.G. Edwards & Sons, Inc., Decision 02-196 (N.Y.S.E Hearing Panel, October 2, 2002) involved failure of supervision relating to the marketing and sale of callable certificates of deposit and the recommendation and sale of securities to customers which were unsuitable. The decision also included numerous other unrelated violations. The respondent stipulated to a censure, a \$400,000 fine and an undertaking to conduct a review of the Firm's policies, procedures, practices and supervisory systems relating to the violations described in the decision.

In re Moors & Cabot, Inc., Decision 05-83 (N.Y.S.E. Hearing Panel, August 5, 2005) involved improper on-Floor trading and numerous violations concerning the error account. The respondent also failed to have adequate supervision, controls and procedures for oversight of the error account. The decision also included several other unrelated violations. The respondent stipulated to a censure and a fine of \$250,000. The respondent was subject to disciplinary action five years earlier for substantially similar failures.

In re Nikko Securities Co. International, Inc., Decision 93-104 (N.Y.S.E. Hearing Panel, July 26, 1993) involved employees who were not registered performing duties which required registration and a failure to maintain appropriate procedures of supervision and control with respect to the registration of employees. The respondent consented to a censure, a \$250,000 fine and an undertaking. Two years prior to this decision the respondent was disciplined for failing to register employees.

The conduct in the present case involves serious violations that impacted adversely on customers. Additionally, Respondent Firm had a previous related disciplinary matter. The penalty imposes both a fine, convertible to customer restitution, a sum for customer restitution, settlement and customer restitution procedures and an undertaking.

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by Respondent Firm of censure, a total payment to the Exchange of \$550,000 and an undertaking as set forth below. Such payment shall be made to the Exchange within 15 days of the Hearing Panel's decision becoming final in this matter (the "Final Date") and will be apportioned as follows:

1. \$175,000, which shall constitute a fine (the "Fine") and may be used, in whole or part, to supplement the funds described in paragraph 2 immediately below and,
2. \$375,000, which shall be used, in whole or part, to compensate customers as described below that have been injured by Respondent Firm's violative conduct as described herein (the "Restitution Funds").

The following are the settlement and customer restitution procedures:

1. Within ten days of the Final Date, the Exchange shall establish an escrow account (the "Escrow Account"). Thereafter, upon receipt of the Restitution Funds, the Exchange shall fund the Escrow Account with such funds. The Escrow Account shall be managed by an escrow agent (the "Escrow Agent") who will be appointed by, and at the sole discretion of, the Exchange.
2. Within 30 days of the Final Date, Respondent Firm shall contact the relevant customers and/or the issuers of the annuities that they purchased during the Relevant Period, and obtain, to the extent available, transactional documentation sufficient for an expert (the "Expert") to conduct a damage analysis for those customers for whom such documentation is missing from Respondent Firm's files and therefore has not been produced to Enforcement. The Expert shall be appointed by, and at the sole discretion of, the Exchange.
3. Within 90 days of the Final Date, Respondent Firm shall submit to Enforcement: (i) any additional transactional documentation that it has obtained from customers or annuity issuers as set forth above; (ii) a final list of all customers who executed annuity switches during the Relevant Period (the "Final Customer List"); and (iii) a certification signed by Respondent Firm's Chief Executive Officer that (a) states Respondent Firm has made a diligent and good-faith effort to obtain the documentation and other information referred to in this paragraph, and (b) sets forth in detail the steps taken by Respondent Firm in connection therewith. The Final Customer List shall contain the last known address and telephone number of the customers identified thereon.
4. Thereafter, the Expert shall prepare damage calculations for all customers of Respondent Firm for which Respondent Firm has provided sufficient data (the "Preliminary Damage Calculations").
5. Upon receipt of the Preliminary Damage Calculations, Respondent Firm shall have ten days to submit to Enforcement a statement that sets forth: (i) any changes that it believes should be made to such calculations so that they fairly and accurately reflect the damages sustained by the relevant customers as a result of the annuity switches at issue, and (ii) detailed reasons supporting such changes (the "Proposed Changes").
6. The Expert shall consider the Proposed Changes and make, within his sole discretion, any changes he deems necessary to the Preliminary Damage Calculations, thus creating the "Final Damage Calculations."
7. Upon receipt of the Final Damage Calculations, Enforcement shall direct the Escrow Agent to, as set forth in the Stipulation and Consent, compensate customers who effectuated unsuitable annuity switches and have been injured as indicated by such calculations (an "Injured Customer") from the Restitution Funds.

8. In the event that the Restitution Funds are insufficient to compensate all Injured Customers in the amounts of the Final Damage Calculations, the Fine shall, in whole or in part, be added by the Exchange to the Restitution Funds and be used to make restitution payments to such Injured Customers as set forth in the Stipulation and Consent.
9. In the event that the amount constituting the sum of the Restitution Funds and the Fine is insufficient to fully compensate all Injured Customers in the amounts set forth in the Final Damage Calculations, each Injured Customer shall be compensated on a pro rata percentage of their damages based on the amount of the Escrow Funds that are available.
10. In the event that the Escrow Account contains any funds after all Injured Customers identified on the Final Customer List have been compensated, such funds shall be sent by the Escrow Agent to the Exchange and shall constitute a penalty. In no event shall any payments made to the Escrow Account pursuant to the Stipulation and Consent be refunded to Respondent Firm.
11. Regardless of whether or not the Fine is used, in whole or part, to make restitution payments to Injured Customers as provided above, such amount shall be treated by Respondent Firm as a penalty for all purposes, including tax and insurance purposes.

Undertaking

12. Within 30 days from the Final Date, Respondent Firm shall retain an outside consultant (the "Consultant"), not unacceptable to the Exchange, to perform a review and prepare a report (the "Report") that contains recommendations concerning Respondent Firm's policies, procedures and practices relating to the sale and supervision of variable annuities (including annuities switches) by Respondent Firm.
13. Within 180 days from the Final Date, the Consultant shall provide Respondent Firm's Board of Directors and Enforcement with a copy of the Report.
14. Respondent Firm shall adopt and implement all policies, procedures, and practices recommended in the Report; provided, however, that as to any recommendation which Respondent Firm, with the consent of its Board of Directors, determines is, in whole or part, inappropriate, unnecessary or unduly burdensome, Respondent Firm may propose to the Consultant alternative policies, procedures and practices that are designed to achieve the same objective or purpose as those recommended in the Report ("Alternative Procedures").
15. In the event that Respondent Firm proposes Alternative Procedures to the Consultant as referred to above, Respondent Firm shall provide Enforcement with a written representation that such Alternative Procedures have been presented to the Consultant with a description of how such Alternative Procedures achieve the same objective or purpose as the Report's original recommendation.

16. In the event the Consultant is not satisfied that such Alternative Procedures achieve the same objective or purpose as the Report's original recommendations, Respondent Firm shall implement the policies, procedures, and practices recommended in the Report.
17. Within 60 days of delivery of the Report to its Board of Directors, Respondent Firm shall submit to Enforcement a written representation, signed by the Chief Executive Officer, setting forth the details of Respondent Firm's implementation of the recommendations contained in the Report, or the Alternative Procedures, if agreed to by the Consultant.

For the Hearing Panel

Vincent F. Murphy - Hearing Officer
Panelists:
John Cirrito
Laurence A. Shaddek