

1 STATE OF WASHINGTON

2 DEPARTMENT OF FINANCIAL INSTITUTIONS
3 SECURITIES DIVISION

4 IN THE MATTER OF) Order Number: S-04-053-05-CO01
5 Waddell & Reed, Inc., and)
6 W & R Insurance Agency, Inc.) CONSENT ORDER
7 Respondents.)

8 STATE OF WASHINGTON

9 OFFICE OF INSURANCE COMMISSIONER

10 IN THE MATTER OF) No. D-05-361
11 Waddell & Reed, Inc., and)
12 W & R Insurance Agency, Inc.) CONSENT ORDER
13 Respondents.)

14
15 WHEREAS, Waddell & Reed, Inc. is a broker-dealer registered in the State of
16 Washington, and W & R Insurance Agency, Inc. is a licensed insurance agency in the State of
17 Washington (respondents collectively referred to as “Waddell & Reed” hereafter); and

18 WHEREAS, coordinated investigations have been conducted by members of a multi-
19 state group of securities and insurance regulators into Waddell & Reed’s suitability
20 determinations and sales practices, in connection with Waddell & Reed selling variable annuity
21 investments held by customers and then purchasing similar products issued by a different
22 insurer; and

1 WHEREAS, Waddell & Reed has provided information to regulators conducting the
2 investigations by responding to inquiries, providing documentary evidence and other materials,
3 and providing regulators with access to facts relating to the investigations, and has entered into
4 a separate settlement with the NASD relating to the challenged conduct; and

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

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

10 WHEREAS, Waddell & Reed elects permanently to waive any right to a hearing and
11 appeal under the Revised Code of Washington (“RCW”) 34.05 with respect to this Consent
12 Order (the “Order”);

13 NOW, THEREFORE, the Securities Administrator, as administrator of the Securities
14 Act of Washington, RCW 21.20, and the Insurance Commissioner pursuant to his authority to
15 enforce the Washington Insurance Code hereby enter this Order:

16 I. FINDINGS OF FACT

17 A. Jurisdiction

18 1. Waddell & Reed, Inc. (CRD No. 866) is currently, and at all times relevant to
19 this Order was, registered in Washington as a broker-dealer. Waddell & Reed also is a federal-
20 covered investment adviser.

21 2. W & R Insurance Agency, Inc. is a licensed insurance agency in the State of
22 Washington.

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

3 10. Variable annuities have features of both securities and insurance products. The
4 insurance part of the product is a guarantee of income for the life of the customer or the life of
5 some other person designated by the customer, or for a specified period. The annuities also
6 provide a death benefit, typically the greater of the contract value or net purchase payments.
7 The amount of money placed into the variable annuity by the customer is invested in one or
8 more subaccounts, which include mutual funds and money market accounts. The return
9 received by variable annuity customers varies according to the performance of the subaccounts
10 underlying the annuity. In this case, the subaccounts were created and managed by a Waddell
11 & Reed affiliate.

12 11. The purchaser of an annuity through Waddell & Reed could decide in which
13 Waddell & Reed mutual funds to invest the funds placed into the annuity. In the case of
14 United Investors Life Insurance Company (“UILIC”), customers could choose from among a
15 fixed account and eleven mutual fund and money market subaccounts offered by Waddell &
16 Reed including a bond fund, international stocks, money market instruments, small-capital
17 companies, and technology stocks. Customers could divide their funds among these funds.
18 Waddell & Reed’s financial advisors assist customers in evaluating the subaccount portfolios
19 and allocating annuity monies among the portfolios. The value of these variable annuities will
20 change over time, according to the performance of the subaccount portfolios into which the
21 customer has placed his or her funds.

22 12. Most annuities, like those sold by Waddell & Reed, impose no front-end
23 commissions purchase fees or sales charges added to the purchase price. They are, however,

1 subject to the imposition of ongoing fees, assessed as a percentage of the money deposited into
2 the annuity.

3 13. The UILIC Advantage II variable annuity had an 8.5% sales charge (paid on a
4 deferred basis of 85 basis points per year for ten years), a .90% annual mortality and expense
5 fee (“M&E fee”), based on the current value of the investment, and a \$50 annual fee for the
6 life of the investment. The UILIC Advantage Gold variable annuity has no front-end fee, a
7 1.40% annual M&E fee, based on the current value of the investment, and a \$25 annual fee for
8 the life of the investment (waived for contracts over \$25,000).

9 14. The Waddell & Reed Advisors Select Annuity issued by Nationwide, had no
10 front-end fee, a 1.35% annual M&E fee, and a \$30 annual administrative charge on policies
11 valued at less than \$50,000. The Waddell & Reed Advisors Select Plus Annuity had no front-
12 end fee and a .95% annual M&E fee.

13 15. All four of the variable annuities had Contingent Deferred Sales Charges
14 (“CDSC”). A CDSC is an amount that must be paid upon the withdrawal from or exchange of
15 the variable annuity if the withdrawal from or exchange occurs within a specified period of
16 time. The amount is paid as a percentage of the money deposited into the annuity.

17 16. The UILIC Advantage II variable annuity carried a CDSC for the first eight
18 years, declining 1% per year from 8% in the first year to 1% in the eighth year. The UILIC
19 Advantage Gold variable annuity had a CDSC for the first seven years, declining 1% per year
20 from 7% in the first year to 1% in the final year. Each additional purchase payment carried a
21 CDSC.

22 17. The CDSC for the Waddell & Reed Advisor’s Select Annuity lasted for eight
23 years and declined 1% per year from 8% in the first and second years to 2% in the eighth year.

1 (This could be reduced to seven years at an additional cost of 5 basis points per year, based on
2 current value.)

3 18. The CDSC for the Waddell & Reed Advisor's Select Plus Annuity lasted for
4 seven years and declined 1% per year from 7% in the first and second years to 2% in the
5 seventh year. (This could be reduced to five years at an additional cost of 15 basis points per
6 year, based on current value.)

7 19. Waddell & Reed financial advisors who sold the variable annuities at issue
8 received up-front commissions for each sale. Commissions on the products at issue ranged
9 from 5-7.5%. The commission was paid by the insurance company to Waddell & Reed, which
10 then paid part of the commission to the financial advisor. The commission paid to the financial
11 advisor, however, did not come out of the principal amount invested by the customer in the
12 annuity. Instead, the insurance company paid the commissions from its own funds and
13 recouped that payment through the asset-based fees assessed each customer on an annual basis.

14 20. If the customer withdraws her funds from a variable annuity before the
15 insurance company has recouped the commission it has paid to the financial advisor, the
16 insurance company might lose the money paid as commission to the financial advisor. To
17 protect against this, insurance companies commonly impose contingent deferred surrender
18 charges ("CDSCs") on annuity customers. If the customer withdraws her funds within the
19 "surrender period" of an annuity, the customer must pay a surrender charge to the insurance
20 company.

21 **C. United Investors Variable Annuities**

22 21. United Investors Life Insurance Company ("UILIC") was founded by Waddell
23 & Reed in 1961. Between 1961 and 2001, UILIC was the principal sponsor of the variable

1 annuities sold by Waddell & Reed. In the 1980s, Waddell & Reed and UILIC were purchased
2 by Torchmark, Inc. Both remained subsidiaries of Torchmark until November 1998, when
3 Waddell & Reed was spun-off into a separate publicly-traded company. UILIC has remained a
4 subsidiary of Torchmark.

5 22. Before Waddell & Reed was spun off by Torchmark, Waddell & Reed and
6 UILIC entered into a Principal Underwriting Agreement and General Agency Contract. These
7 agreements allowed Waddell & Reed to sell certain UILIC products and permitted Waddell &
8 Reed's registered representatives to act as authorized insurance financial advisors (producers)
9 for UILIC. These agreements were renewed and amended periodically between 1998 and
10 2001.

11 23. Prior to 2000, the only UILIC variable annuity product offered through Waddell
12 & Reed was called Advantage II. Advantage II is a deferred variable annuity policy issued by
13 UILIC. Advantage II, through W&R Target Funds, offers the eleven mutual fund choices
14 described above.

15 24. In 2000, Waddell & Reed began offering a new product created by UILIC,
16 called Advantage Gold. Advantage Gold had more options and different features than the
17 Advantage II. Advantage Gold, through W&R Target Funds, offered to policy owners the
18 same eleven mutual fund choices that are offered by Advantage II.

19 25. UILIC charges its variable annuity customers various fees including annual fees
20 and annual mortality and expense (M&E) charges (which are based on the size of the annuity).

21 26. In about 1999, Waddell & Reed requested that UILIC share with it a portion of
22 the M&E charges that UILIC collected from Waddell & Reed customers. UILIC did agree to
23 share 25 basis points of the M&E fees with Waddell & Reed on annuity products developed in

1 the future, and 20 basis points of the M&E fees generated for existing products already held by
2 customers. The parties later had a dispute as to whether the agreement was legally binding
3 based on terms unrelated to compensation. This dispute resulted in a lawsuit filed by UILIC
4 against Waddell & Reed in May 2000 in the state of Alabama.

5 **D. Nationwide Annuities**

6 27. In early 2000, based on the deteriorating relationship between Waddell & Reed
7 and UILIC, Waddell & Reed began searching for variable annuity products issued by a
8 different insurance company.

9 28. Waddell & Reed began discussions with Nationwide around this time.

10 29. As part of this process, Waddell & Reed analyzed the potential profitability to
11 the firm of switching the firm's variable annuity business from UILIC to another insurance
12 company. Waddell & Reed's profitability projections assumed that 90% of its annuity
13 customers who would not have to pay surrender penalties would switch to annuities issued by a
14 new insurance company. The company expected that between 20 and 65% of customers who
15 would have to pay surrender charges would still agree to exchange their UILIC annuities for
16 annuities issued by a new insurance company chosen by Waddell & Reed.

17 30. In October, 2000, Waddell & Reed finalized an agreement with Nationwide.
18 Under this agreement, Nationwide created two new variable annuity products and agreed to let
19 Waddell & Reed financial advisors sell insurance as financial advisors and agents for
20 Nationwide. In December 2000, Waddell & Reed began selling Nationwide annuities
21 alongside those of UILIC.

22 31. By March of 2001, Waddell & Reed was soliciting many of its customers to
23 exchange their UILIC annuities for those issued by Nationwide.

1 **E. Annuity Comparisons**

2 32. Waddell & Reed worked with Nationwide to create products that would provide
3 “the best opportunity for a clean case of 1035 [exchange of variable annuities].” Nationwide
4 assisted in the design of products specifically for the purpose of replacement.

5 33. There were many similarities between Nationwide’s annuities and those of
6 UILIC being exchanged.

7 A. The annuities from both Nationwide and UILIC were based on investment
8 portfolios made up of Waddell & Reed mutual funds. The Nationwide annuities
9 gave customers a choice of twelve mutual fund options and a fixed account
10 option; eleven of the twelve mutual fund options were identical to the choices
11 available with the UILIC policies. The additional portfolio option added for the
12 Nationwide annuities was a “Value Portfolio.”

13 B. They both provided death benefits for annuity customers, charged annual
14 mortality and expense (M & E) fees, imposed CDSCs, and made available
15 (sometimes at an extra charge) additional insurance benefits.

16 34. The Nationwide annuities did have some ways in which they differed from the
17 UILIC annuities:

18 A. The UILIC annuities had an up-front 8.5% sales charge that was collected over
19 a ten-year period. The Nationwide annuities had no sales charge.

20 B. UILIC annuities imposed .90% of the annuity’s value annually as M&E
21 charges. The Nationwide Select annuity charged 1.35% annually while Select
22 Plus charged customers .95% each year.

1 C. The UILIC Advantage II annuities charged a \$50 annual policy fee. The Select
2 annuities imposed a \$30 fee (waived when the contract value exceeded
3 \$50,000); Select Plus products imposed no annual policy fee.

4 D. The UILIC Advantage II annuity carried a CDSC for the first eight years,
5 declining 1% per year from 8% in the first year to 1% in the eighth year. The
6 UILIC Advantage Gold annuity had a CDSC for the first seven years, declining
7 1% per year from 7% in the first year to 1% in the final year. Each additional
8 purchase payment carried a new CDSC.

9 E. The CDSC for the Waddell & Reed Advisor's Select Annuity lasted for eight
10 years and declined 1% per year from 8% in the first and second years to 2% in
11 the eighth year. (This could be reduced to seven years at an additional cost of 5
12 basis points per year, based on current value.)

13 F. The CDSC for Waddell & Reed Advisor's Select Plus Annuity lasted for seven
14 years and declined 1% per year from 7% in the first and second years to 2% in
15 the seventh year. (This could be reduced to five years at an additional cost of
16 15 basis points per year, based on current value.)

17 G. The death benefit under the annuities generally was based on the size of the
18 annuity. In some cases, due to the payment of surrender charges, customers
19 may have had a smaller death benefit at Nationwide than with UILIC. The
20 death benefit under the UILIC policies ratcheted up and locked in on the eight-
21 year anniversary contract value and again on year sixteen, to whichever value
22 was higher, although any step up of death benefits under the Advantage II that
23 had been achieved disappeared if the policy holder lived past age 74.

1 H. The Select Plus product has, as a standard feature, a “five-year reset” of death
2 benefit, under which Nationwide paid the highest of (1) premiums paid (less
3 any withdrawals), (2) the market value of subaccounts, or (3) the market value
4 of the subaccounts on the most recent five-year anniversary of policy issuance
5 before the policyholder’s 86th birthday. This means that the value of the death
6 benefit reset after five years could be reduced if the contract value of the
7 annuity had dropped based on stock market performance during the preceding
8 five years (but it would never be less than the net purchase value). Clients were
9 able to take advantage of the last-occurring reset, even after age 86.

10 I. There were variations on the insurance benefits available from each company.
11 In some instances, insurance coverage for long-term confinement, disability,
12 nursing home expenses, and terminal illnesses were included as part of UILIC’s
13 Advantage Gold product, and to a lesser degree the Advantage II product, but
14 were optional riders on the Nationwide policies.

15 35. Some of these differences benefited customers. Other differences were minor
16 and may have created the appearance that they were giving added benefits to customers.
17 Some of the differences were detrimental to customers who exchanged out of UILIC annuities
18 and into Nationwide annuities.

19 36. In general, the differences meant that the UILIC products were more expensive
20 at the outset, but the Nationwide products would become more expensive over time due to the
21 higher M&E charges. The higher the value of the annuity, the more quickly the Nationwide
22 products became more expensive than those from UILIC.

1 **F. Extra Value Rider and the Select Annuity**

2 37. One new feature offered with the Select Plus product was an extra value rider,
3 or the so-called “bonus” feature. Customers who chose this feature would receive a 3% credit
4 to their investment by purchasing a special rider. Customers choosing this 3% extra value
5 rider feature were required to pay 45 basis points (.45%) of the annuity value per year for this
6 feature. Training and compliance manuals for Waddell & Reed financial advisors emphasized
7 that an annuity would have to reach a rate of return of at least 7.75% in order to pay for the
8 cost of this extra value rider. Several of the mutual fund portfolios offered by Waddell & Reed
9 were bond funds and money market funds; there was no reasonable expectation that they
10 would achieve a 7.75% rate of return justifying the selection of this extra value rider. In
11 addition, this extra value rider was not suitable for investors intending to make additional
12 purchase payments beyond the first year.

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

19 **G. Impacts of the Exchanges**

20 39. Waddell & Reed benefited from the exchanges in two primary ways. First, the
21 firm and its financial advisors earned a new commission on each annuity exchange. Second,
22 Waddell & Reed began earning a 25 basis point fee from the M&E charges collected by
23

1 Nationwide; one quarter of one percent of the value of all annuities moved to Nationwide was
2 paid to Waddell & Reed annually.

3 40. Customers were put at risk of suffering several harms:

4 A. Surrender Charges: At the urging of Waddell & Reed and its financial advisors,
5 customers surrendered 6,742 UILIC annuities worth approximately \$616
6 million. Of these, 4,937 incurred surrender charges (73%) and 1,835 required
7 no surrender charges. The total amount of surrender charges paid by customers
8 to UILIC for these exchanges was \$9,667,266.

9 B. M&E Charges: Select Plus customers would have paid higher ongoing M&E
10 fees to Nationwide (.95% per year) than they would have paid to UILIC (.90%)
11 after the 10 year period of 85 basis points sales charge on any purchase
12 premiums. Customers having Select annuities paid annual charges equal to
13 1.35% of the value of their annuities.

14 C. New CDSC: When the exchange was made, each customer became subject to a
15 new surrender period of seven or eight years, depending on the annuity. This
16 meant that a customer deciding to withdraw her funds from a Nationwide
17 annuity before the surrender period has expired would have to pay a surrender
18 charge when there might have been no surrender charge had the annuity
19 remained at UILIC (or at least a reduced surrender charge due to the passage of
20 time).

21 D. Reduced Death Benefits: Customers exchanging their policies were at risk of
22 recovering a lower benefit in the event of death during the term of the annuity.
23 This could occur either of two ways. First, the value of a death benefit

1 ordinarily was based on the value of funds in the annuity. Some customers who
2 paid a surrender charge to UILIC transferred a lesser amount of money to
3 Nationwide than the customer had at UILIC, resulting in a lower death benefit.
4 Second, the UILIC policies gave customers the advantage of a greater death
5 benefit if the value of the annuity was higher after eight years. The Nationwide
6 policies provided that the death benefit could be lower if the stock market
7 performance had reduced the value of the annuity on the “reset” dates.

8 E. Extra Value Rider: Some customers purchased the so-called “bonus” rider,
9 entitling the customer to a 3% credit to his first year’s purchase payments bonus
10 in income if the customer paid the annual .45% fee for the rider. But, many
11 customers had funds in money market or bond funds that were paying and
12 expecting to pay considerably less than the 7.75% annual return needed to break
13 even on the bonus. Others made additional purchase payments after the first
14 year, raising the break-even point above 7.75%.

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

19 41. As a result of the potential disadvantages to customers, many of the customers
20 who paid surrender charges as part of the annuity exchanges were likely to lose money or
21 receive reduced benefits by making the switch.
22
23

1 **H. Termination of Waddell & Reed/UILIC Relationship**

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

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

12 A. January 31, 2001: Waddell & Reed sent a memorandum to “All Field
13 Personnel” saying, “UILIC is no longer interested in a constructive relationship
14 with Waddell & Reed whereby you and your clients can receive the competitive
15 products and services to which you are entitled.”

16 B. February 9, 2001: The company sent another memorandum to the Waddell &
17 Reed sales force “to stress, again, that you should continue to use Nationwide
18 products wherever appropriate.” Advisors were told that “UILIC no longer
19 appears to value a constructive, mutually supportive relationship with Waddell
20 & Reed,” but were not fully informed about the core dispute underlying the
21 break with UILIC.

1 C. February 15, 2001: Another memorandum said the advisors should be
2 undeterred in recommending Nationwide products for clients, where it could be
3 justified as appropriate and suitable.

4 D. March 6, 2001: Waddell & Reed issued a memorandum to the sales force with a
5 “Question and Answer” attachment. These materials informed financial
6 advisors that the UILIC underwriting agreement would be terminated April 30,
7 2001.

8 i. The memorandum warned that after termination of the underwriting
9 agreement, UILIC “has the right to reassign variable annuity policies to
10 non-Waddell & Reed representatives.” Advisors were told that if this
11 occurred, the trailing commissions being paid to the financial advisors
12 would cease. Moreover, if a new financial advisor were assigned to the
13 customers, there would be confusion for the customer and competition
14 for the customer’s trust between the new financial advisor and the
15 Waddell & Reed financial advisor.

16 ii. The company stated doubts that “one might question [UILIC’s]
17 incentive to provide us a high level of service.”

18 iii. Financial advisors were told it “is very important that . . . you be
19 especially proactive with your clients and take necessary steps to protect
20 your relationships with them.”

21 iv. The company said a list of UILIC annuities in force would be sent to all
22 supervisors so financial advisors could “utilize that information as
23 appropriate in securing your client relationships.”

1 v. The memorandum noted that there could be no assurance that UILIC
2 would continue to provide account information to the financial advisors.

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

8 44. Some Waddell & Reed regional vice presidents (RVPs) began taking steps to
9 encourage contacts with clients. One sent an e-mail to each of his division managers
10 encouraging a "campaign of every advisor contacting every UILIC client" to explain what was
11 happening with the UILIC relationship. Another told his division managers to have financial
12 advisors set up meetings with all UILIC clients to "solidify our relationships." A third RVP
13 advised division managers and advisors that they need to "secure your client base, because
14 that's their livelihood." An financial advisor reported to company officials that "the vast
15 majority of clients are not wanting to stay with UILIC once they hear how they [UILIC] are
16 cutting me off from servicing the accounts."

17 45. Waddell & Reed lacked a reasonable basis for many of the assertions in the
18 March 6, 2001 memorandum and the conference call. The company did not know how the
19 termination of the relationship with UILIC would affect Waddell & Reed's customers. The
20 company had not sought information or assurances from UILIC regarding the concerns raised
21 in the March 6 memorandum and the conference call.

22 46. As a result of these memoranda from the company, Waddell & Reed advisors
23 began moving customers from UILIC to Nationwide annuities.

1 47. On March 14, 2001, the president of UILIC wrote a letter to Waddell & Reed
2 assuring Waddell & Reed that UILIC would continue to provide compensation to Waddell &
3 Reed advisors and would continue to provide service to both customers and financial advisors.

4 48. After receiving these assurances from UILIC, Waddell & Reed continued to
5 encourage advisors to move clients away from their UILIC accounts. At this time, Waddell &
6 Reed's president suggested that as the advisors discuss UILIC annuities with their clients, the
7 advisors could indicate concern that UILIC's financial condition could deteriorate to the point
8 it might cease being viable and that UILIC's employees might be demoralized, resulting in
9 high turnover and inferior customer service.

10 49. On April 6, 2001, Waddell & Reed sent a memorandum to all division
11 managers that included a list of UILIC policies for each financial advisor in the district, a
12 question and answer sheet, and a letter that could be sent to UILIC clients.

13 A. The question and answer sheet gave little guidance to the advisor in determining
14 the suitability of an exchange. However, it did list factors which could be taken
15 into account in deciding whether to recommend an exchange. These factors
16 included the client's desire to remain with the Waddell & Reed advisor and
17 concern whether UILIC would service the annuity properly in the future. This
18 document cast doubt on whether UILIC would live up to its commitment of
19 continued service and raised the possibility that UILIC would close or fail as a
20 result of severing its ties to Waddell & Reed.

21 B. The letter to customers said while the UILIC annuities would continue in effect,
22 the annuities might be reassigned to "another financial advisor from a company
23 other than Waddell & Reed." The letter informed customers that their Waddell

1 & Reed financial advisor would contact them to review their needs “and to
2 determine what action, if any, we should take to ensure that [the customer’s
3 needs] continue to be met.” Customers that received the letter believed that
4 without the change, Waddell & Reed’s financial advisors would not be able to
5 service their accounts.

6 50. Waddell & Reed’s efforts to promote these exchanges continued despite
7 concern expressed by some financial advisors.

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

12 B. Some financial advisors expressed concern about increased regulatory scrutiny
13 of annuity exchanges and urged other advisors to review the NASD suitability
14 guidelines and the results of enforcement cases where other firms had been
15 accused of churning customer accounts.

16 C. An e-mail by one advisor to company management asked whether Waddell &
17 Reed would mitigate the impact of surrender charges that will exceed 3% and
18 whether the company would defend the financial advisors in litigation if the
19 suitability of the exchange were challenged.

20 D. Another financial advisor, recognizing that M&E charges, unlike the one-time
21 sales charge, would continue through the life of the annuity and increase as the
22 value of the investment portfolio increased commented: “I also have a family
23 and retirement plans to support but I am having MAJOR problems costing my

1 existing clients more over the long term to support these personal goals.” This
2 financial advisor complained to Waddell & Reed that for some customers, “the
3 charges are too high to warrant switching to Nationwide.”

4 E. In June 2001, when Waddell & Reed’s compliance manager said that retention
5 of the advisor was, by itself, not sufficient to support an exchange
6 recommendation, one supervisor complained “In my 17 years as a division
7 manager, I have not experienced such a ridiculous request from a member of the
8 compliance team.”

9 F. Some financial advisors complained of being pressured by their division
10 managers and regional vice presidents to move clients, when the financial
11 advisors did not feel the exchanges would be suitable for the clients. The
12 advisors were told that if they did not promote the exchanges, “the clients
13 currently assigned to them will be reassigned.”

14 51. Some Waddell & Reed financial advisors welcomed the opportunity to earn
15 commissions with these exchanges. For example, the Select product paid a higher commission
16 to the financial advisor than the Select Plus. One financial advisor, comparing commission
17 payouts of the two products noted: “I have no problem selling an annuity that may cost .45
18 more on M/E charges because I have to support my family and pay my assistant and other
19 business overhead.”

20 52. On May 8, 2001, Waddell & Reed informed its financial advisors of UILIC’s
21 March 14 assurances that it would continue compensating Waddell & Reed financial advisors
22 and would service customers and financial advisors.

1 53. On May 16, 2001, Waddell & Reed entered into a selling agreement with
2 another financial services firm that, in turn, had an underwriting agreement with UILIC. This
3 guaranteed the ability of Waddell & Reed advisors to continue servicing all remaining UILIC
4 policies and to receive information about UILIC products. However, Waddell & Reed did not
5 convey this information to its financial advisors until June 12. When this information became
6 known among Waddell & Reed’s financial advisors, the volume of annuity exchanges began to
7 decline significantly. Around this time, Waddell & Reed also adopted a new “Variable
8 Product Suitability Form” and required financial advisors to begin using it.

9 **I. Waddell & Reed’s Efforts to Exchange Annuities**

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

15 **J. Suitability of the Exchanges**

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

18 Advisors should be very careful when recommending that a client make a change of
19 investment (i.e., switching from one variable product to another or switching from a non-
20 variable investment to a variable product) in their portfolio. Because investment changes often
21 result in new costs to a client, a client should be advised of any option to conduct a change
22 without new or additional costs. Before recommending any change in a client’s portfolio, it is
23 imperative that the client understand all applicable expenses and fees involved in the change

1 and any resulting tax consequences. All recommendations must be clearly in the best interests
2 of the client and beyond reproach.

3 56. Waddell & Reed instructed its advisors that the exchanges should be suitable
4 for customers. However, some of the company's conduct contributed to a failure to ensure that
5 the transactions were suitable for the customers. These include overstating concerns that
6 UILIC might assign different account representatives or would fail to service the accounts
7 adequately, expressing doubt about the financial stability of UILIC, and unfairly comparing the
8 features, costs, and effects on customers of the different annuity products.

9 57. Waddell & Reed and its advisors did not have adequate mechanisms for
10 measuring or determining the cost and the potential long-term benefit or detriment of an
11 exchange for each customer, taking into account relevant objective factors, including age,
12 sex, surrender charges, M&E expenses, policy features (including annuitization rates), and
13 the costs and benefits of the particular optional policy features chosen by the customers. In
14 addition, Waddell & Reed had no specific guidelines or objective criteria by which advisors
15 could determine whether a potential exchange would be suitable for individual clients or
16 classes of clients.

17 58. As a result of the failure to provide adequate analytical tools or guidelines,
18 Waddell & Reed advisors recommended variable annuity exchanges without having reasonable
19 grounds for believing that the recommendations were suitable for customers based on their
20 security holdings and their financial situations and needs.

21 59. From November 2000 until the spring of 2002, Waddell & Reed periodically
22 revised its order processing, documentation, and review process for variable annuity
23 exchanges. Until at least the spring of 2002, Waddell & Reed's supervisory system was
24 deficient in that it failed to require analysis by division managers or other supervisors to

1 determine the potential costs, benefits, and detriments to the customers of recommended
2 exchanges.

3 60. In addition, the supervisory system did not include specific objective criteria or
4 guidelines which advisors and division managers could apply to determine which categories or
5 proposed exchanges were suitable or unsuitable, or required further review. Without this
6 information, managers were not able to determine whether there was a reasonable basis for a
7 recommended switch between the UILIC and Nationwide variable. In addition, the
8 documentation initially required for approval of variable annuity switches by division
9 managers did not include the reason for the exchange or the amount of surrender charge to be
10 paid.

11 61. Examples of unsuitable transactions included:

12 A. The surrender charges were so significant for customers who had recently
13 purchased UILIC products that a purchase of a substantially-similar Nationwide
14 annuity could not reasonably be expected to result in a net benefit to the
15 customers.

16 B. Over 700 customers were moved from the UILIC Advantage II product to the
17 Select product. The Select product was more expensive than the Select Plus
18 and had fewer benefits overall. In those instances in which a Select policy had
19 features not automatically included in the Select Plus product, those features
20 could have been added as riders to the Select Plus product for a lower cost than
21 purchasing the Select product. There were few, if any, circumstances in which
22 a customer would be better off by buying the Select product rather than Select
23 Plus.

1 C. The extra value (bonus) rider was not suitable for customers intending to make
2 additional purchase payments beyond the first year as the additional payments
3 may negate any benefit of this rider.

4 D. Some customers were sold a rider allowing annual withdrawals of an additional
5 5% of the investment amount without any indication that the annuity owner
6 expected to withdraw funds before the expiration of the new surrender period.

7 E. A significant number of policies were replaced for reasons that benefited the
8 financial advisor, not the customer. These stated reasons for exchanges
9 included “cancellation of contract with Waddell & Reed,” “Able to service
10 policy,” “reassign the servicing of your policy to another financial advisor,”
11 “change in relationship with Waddell & Reed and United Investors,” “service
12 by a senior financial advisor with Waddell & Reed,” and “overall servicing of
13 accounts.”

14 **K. Dishonest or Unethical Practices**

15 62. Some customers were persuaded to purchase a so-called “bonus” rider (actually,
16 the extra value rider), for which the customers would pay an extra .45% of the value of their
17 annuities each year. The prospectus for the Select Plus Annuity disclosed that this extra value
18 rider could be advantageous only if the value of the mutual funds in the annuity were to rise
19 more than 7.75% each year. While Waddell & Reed offered annuity customers a choice of
20 twelve different mutual funds in which they could allocate their funds, some of the funds
21 targeted safety of principal or income and were not expected to yield a 7.75% return.

22 Customers who were persuaded to purchase the extra value rider, but whose investments were
23

1 allocated into funds where the break-even point was not expected to be realized should not
2 have been encouraged or permitted to purchase the extra value rider.

3 63. Of the 713 customers transferred into Nationwide’s Select products, 622
4 qualified for the Select Plus product. For these customers, the Select Plus product provided
5 better features at lower costs to the customers. The customers should have been placed in the
6 product that offered the best features at the lowest cost. Waddell & Reed financial advisors
7 knew they would receive 7.5% commission on the amount of assets moved to the Select plan,
8 whereas they would receive only 5% commission for customers placed in the Select Plus
9 product.

10 64. Some customers expressed the following to Waddell & Reed relating to the
11 exchanges:

12 A. One customer did not understand the amount he would have to pay in surrender
13 charges. When asked why he had placed his initials on forms approving the
14 exchange, one customer said: “I am 82 years old and I don’t understand these
15 things, we trust [financial advisor] to handle these things.”

16 B. Another customer stated she would not have moved her annuity “if she were not
17 forced” (emphasis in original).

18 C. “But, because I trust him [my advisor] so much, I just tell him to go ahead and
19 do what needs to be done.”

20 D. Another customer described the implicit trust she had in her advisor, saying:
21 “It’s like trusting your doctor. Or your minister.”

22 E. “It was to my best interest. That’s what he told me. . . . I trusted him”
23

1 F. “You know, the only reason that I changed was because I thought my money
2 would earn more with this particular company and my financial advisor
3 recommended it, suggested it. You know, I’m kind of one of those ignorant
4 people that rely on financial advisors”

5 **L. Failure to Perform Adequate Supervision**

6 65. During the Relevant Period, Waddell & Reed’s management failed to maintain
7 and enforce adequate policies, procedures, and systems reasonably designed to prevent the
8 recommendation and execution of unsuitable variable annuity exchanges and to ensure that its
9 financial advisors provided full and accurate disclosures to customers and avoided the use of
10 dishonest or unethical practices.

11 **M. NASD Settlements**

12 66. Waddell & Reed has consented to the entry of an order with the NASD in which
13 Waddell & Reed has agreed to pay a fine of \$5 million, restitution of up to \$11 million, and
14 implementation of corrective action. Robert Hechler, former president of Waddell & Reed,
15 has consented to the entry of an order with the NASD in which he will be suspended from
16 association with any NASD member in any capacity for six months and he will pay a fine of
17 \$150,000. Robert Williams, former national sales manager for Waddell & Reed, also has
18 agreed to pay a fine of \$150,000 and be suspended from association with any NASD member
19 in a principal capacity for six months. Waddell & Reed, Hechler, and Williams neither
20 admitted nor denied the allegations of the NASD Complaint.

21 **II. CONCLUSIONS OF LAW**

22 1. The Department of Financial Institutions, Securities Division, has jurisdiction
23 over this matter pursuant to the Securities Act of Washington, RCW 21.20.

1 1. This Order concludes the investigation by the Department of Financial
2 Institutions, Securities Division and the Office of Insurance Commissioner, and any other
3 action that the Department of Financial Institutions, Securities Division or the Office of
4 Insurance Commissioner could commence under the Securities Act of Washington and the
5 Washington Insurance Code on behalf of the State of Washington as it relates to Respondents
6 Waddell & Reed, Inc. or W &R Insurance Agency, Inc., or any of their Waddell & Reed sister
7 companies, and their current or former officers or directors arising from or relating to the
8 recommendations and transactions by which variable annuities issued by UILIC and held by
9 customers of Waddell & Reed were exchanged into Nationwide products; provided, however,
10 that the Department of Financial Institutions, Securities Division and the Office of Insurance
11 Commissioner may enforce any claims against Respondent arising from or relating to any
12 violation of the provisions of this Order.

13 2. This Consent Order shall become final upon its entry by the Department of
14 Financial Institutions, Securities Division and the Office of Insurance Commissioner.

15 3. Waddell & Reed is censured for its conduct described in this Order.

16 4. As a result of the Findings of Fact and Conclusions of Law contained in this
17 Order and the NASD Order, Waddell & Reed shall establish a fund in the amount of \$11
18 million, which fund shall be used to compensate customers as follows:

19 A. Payment of all surrender charges paid by such customers to UILIC for the
20 exchange of Advantage II variable annuities to Nationwide variable annuities
21 during the period January 2001 through August 2002; and

22 B. Payment to each customer who exchanged an Advantage II variable annuity for
23 a Select variable annuity, who could have purchased a Select Plus variable

1 annuity, in the amount of 2% of the value of the customer's Select annuity at
2 the time of purchase. In the case of customers whose annuities have been
3 terminated through death, lapsation, or otherwise, the amount paid shall be 25
4 basis points for each year that the policy was in effect.

5 5. Waddell & Reed shall, at its own expense, retain an independent consultant not
6 unacceptable to the NASD and the States, to implement the distribution. Waddell & Reed
7 shall cooperate fully with the consultant and shall not place restrictions on the consultant's
8 communications with staff of the Department of Financial Institutions, Securities Division or
9 the Office of Insurance Commissioner.

10 6. Consistent with the NASD Order settling the NASD disciplinary proceedings,
11 Waddell & Reed shall provide the consultant, the NASD, and the States with a proposed
12 schedule of payments, setting out the customers to be compensated and the amount of
13 compensation, and offsets for previous payments. If Waddell & Reed and the consultant are
14 unable to agree as to any disputed payment amount, the determination of the consultant will be
15 final.

16 7. Payments to customers pursuant to this section shall be paid by check and made
17 no later than six months after the entry of this Order. Waddell & Reed and the consultant shall
18 provide a final report of all payments to the NASD and the States, along with supporting
19 documentation, including copies of checks or other evidence of payment requested by the
20 Department of Financial Institutions, Securities Division. Money due to any customer who
21 cannot be located shall be remitted to the escheat fund of the state of the customer's last known
22 residence. After the consultant certifies that all compensation obligations have been fulfilled,
23 the remaining amount in the fund, if any, shall be returned to Waddell & Reed.

1 8. Nothing in this Order shall preclude any customer from pursuing any other
2 remedy to which the customer may be entitled.

3 9. Waddell & Reed shall identify all customers who had a decrease in minimum
4 guaranteed death benefits resulting from an exchange of an Advantage II annuity for a
5 Nationwide annuity. For customers who have died, after exchanging UILIC policies for
6 Nationwide policies, Waddell & Reed already has paid the greater death benefit if the
7 customer's death benefit was reduced by the exchange. Waddell & Reed shall continue to
8 monitor those customer accounts in which the death benefit might be reduced and will pay the
9 greater benefit to the customer. Within thirty days after entry of this Order, Waddell & Reed
10 will notify all customers who are in this situation of this right of reimbursement and will
11 provide to representatives of the States' working group a copy of those notifications.

12 10. Waddell & Reed will continue to provide to the States all documents in its
13 custody and control and make available appropriate witnesses under its control for any further
14 investigations of exchange activity involving variable annuities involving any entity or person
15 other than Waddell & Reed and its current and former officers and directors.

16 11. Waddell & Reed shall provide all information reasonably necessary to the
17 Department of Financial Institutions, Securities Division and the Office of Insurance
18 Commissioner to demonstrate the company's compliance with the terms of this Order.

19 12. The amount of restitution required by this Order to be paid by Waddell & Reed
20 to its customers shall not exceed \$11 million. Waddell & Reed already has provided
21 compensation to customers who purchased the 3% Extra Value Rider ("bonus rider") where
22 the policyholder's portfolio allocation would not be expected to yield the investment return
23 necessary to recoup the cost of the rider. In addition, the company has committed to

1 addressing additional instances in which annuity exchanges were not suitable or where other
2 remediation would be appropriate. Any such additional payments shall be in circumstances or
3 under guidelines established by Waddell & Reed and shall not require approval or notice to the
4 Department of Financial Institutions, Securities Division or the Office of Insurance
5 Commissioner.

6 13. Waddell & Reed shall pay an amount of at least \$95,145.95 to the State of
7 Washington as a fine pursuant to RCW 21.20.110(4), to be credited to the Securities
8 Prosecution Fund, RCW 43.320.115. Payment shall be made in the name of the Washington
9 State Treasurer and delivered to the Securities Administrator, Department of Financial
10 Institutions, PO Box 9033, Olympia, WA 98507-9033, and submitted with a cover letter that
11 identifies this matter by caption and order number and the amount as an administrative fine.
12 This amount constitutes Washington's proportionate share of the state settlement amount of
13 Two Million Dollars (\$2,000,000). This amount shall be paid to the State within ten days of
14 the entry of this Order. Any amount of this \$2 million penalty for the states that remains on
15 October 31, 2005, based on any states deciding not to join the multistate settlement in this
16 matter, will be allocated proportionately among the states participating in this settlement
17 (based on the number of exchanges in each state) and paid to these states by December 31,
18 2005.

19 14. If Waddell & Reed enters into a settlement with any state securities or insurance
20 enforcement agency that is not generally consistent with the multistate settlement proposed
21 ("non-joining state") relating to the matters described in this Order, for an amount greater than
22 the amount the non-joining state would have received under the multistate settlement, Waddell
23

1 & Reed shall pay the State of Washington, as set forth in paragraph 13, an amount sufficient to
2 give the State of Washington the same proportionate recovery as paid to the non-joining state.

3 15. If payment is not made by Waddell & Reed as required by this Order, the
4 Department of Financial Institutions, Securities Division, or the Office of Insurance
5 Commissioner may vacate this Order, at their sole discretion, upon ten days notice to Waddell
6 & Reed and without opportunity for administrative hearing and Waddell & Reed agrees that
7 any statute of limitations applicable to the subject of the investigation and any claims arising
8 from or relating thereto are tolled from and after the date of this Order until such date that the
9 Department of Financial Institutions, Securities Division, or the Office of Insurance
10 Commissioner vacates this Order.

11 16. This Order is not intended by the Department of Financial Institutions,
12 Securities Division or the Office of Insurance Commissioner, to subject any Covered Person to
13 any disqualifications under the law of the United States, any state, the District of Columbia or
14 Puerto Rico, including, without limitation, any disqualifications from relying upon the state or
15 federal registration exemptions or safe harbor provisions. "Covered Person" means Waddell &
16 Reed or any of its affiliates or their current or former officers, directors, employees, or other
17 persons that otherwise would be disqualified as a result of the Orders (as defined below).

18 17. This Order and the order of any other State in related proceedings against
19 Waddell & Reed (collectively, the "Orders") shall not disqualify any Covered Person from any
20 business that he or she otherwise is qualified, licensed, or permitted to perform under
21 applicable laws of Washington and any disqualifications from relying upon this State's
22 registration exemptions or safe harbor provisions that arise from the Orders are hereby waived.

1 18. For any person or entity not a party to this Order, this Order does not limit or
2 create any private rights or remedies against Waddell & Reed including, without limitation, the
3 use of any e-mails or other documents of Waddell & Reed or of others regarding variable
4 annuity exchanges or limit or create liability of Waddell & Reed or limit or create defenses of
5 Waddell & Reed to any claims.

6 19. This Order and any dispute related thereto shall be construed and enforced in
7 accordance, and governed by, the laws of the State of Washington, without regard to any
8 choice of law principles.

9 20. Waddell & Reed agrees not to take any action or to make or permit to be made
10 any public statement denying, directly or indirectly, any finding in this Order or creating the
11 impression that this Order is without factual basis. Nothing in this Paragraph affects Waddell
12 & Reed's (i) testimonial obligations or (ii) right to take legal or factual positions in defense of
13 litigation or in defense of a claim or other legal proceeding in which the Department of
14 Financial Institutions, Securities Division or the Office of Insurance Commissioner is not a
15 party.

16 21. Waddell & Reed, through its execution of this Consent Order, voluntarily
17 waives its right to a hearing on this matter and to judicial review of this Order pursuant to
18 RCW 21.20.440, RCW 48.04.010, and RCW 34.05.

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1 Dated and Entered this 8th day of August, 2005.

2
3 

4 _____
MICHAEL E. STEVENSON
Securities Administrator

5
6 /s/ John F. Hamje

7 JOHN F. HAMJE
Deputy Insurance Commissioner
Consumer Protection Division
8 Washington State Office of
9 Insurance Commissioner

10 **CONSENT TO ENTRY OF ORDER BY**

11 **WADDELL & REED, INC. AND W & R INSURANCE AGENCY, INC.**

12 1. Waddell & Reed, Inc. and W & R Insurance Agency, Inc. hereby acknowledge
13 that they have been served with a copy of this Order, have read the foregoing Order, are aware
14 of their right to a hearing and appeal in this matter, and have waived the same.

15 2. Waddell & Reed, Inc. and W & R Insurance Agency, Inc. admit to the
16 jurisdiction of the Department of Financial Institutions, Securities Division, and the Office of
17 Insurance Commissioner, neither admit nor deny the Findings of Fact and Conclusions of Law
18 contained in the Order, and consent to entry of this Order by the Securities Administrator and
19 the Office of Insurance Commissioner as settlement of the issues contained in this Order.

20 3. Waddell & Reed, Inc. and W & R Insurance Agency, Inc. state that no promise
21 of any kind or nature whatsoever was made to it to induce it to enter into this Order and that
22 they have entered into this Order voluntarily.

23 4. _____ Thomas Butch _____ represents that he/she is President and
24 Chairman of the Board of Waddell & Reed, Inc. and that, as such, has been authorized by

1 Waddell & Reed, Inc. and W &R Insurance Agency, Inc. to enter into this Order for and on
2 behalf of Waddell & Reed, Inc. and W & R Insurance Agency, Inc.

3 5. Waddell & Reed, Inc. and W & R Insurance Agency, Inc. understand that the
4 Department of Financial Institutions, Securities Division or the Office of Insurance
5 Commissioner may make such public announcement concerning this Order and the subject
6 matter thereof as the Department of Financial Institutions, Securities Division or the Office of
7 Insurance Commissioner may deem appropriate.

8
9 DATED this 29th day of July, 2005.

10
11 WADDELL & REED, INC.

12 By: /s/ Thomas Butch

13 Title: President and Chairman of the Board

14 W & R INSURANCE AGENCY, INC.

15 By: /s/ Steve Anderson

16 Title: President

17 SUBSCRIBED AND SWORN TO before me this 29th day of July, 2005.

18
19
20 /s/ Julie A. Brown
Notary Public

21
22 My Commission Expires: 3/16/09