

**STATE OF ILLINOIS
SECRETARY OF STATE
SECURITIES DEPARTMENT**

IN THE MATTER OF:

File Number: 0500402

**Waddell & Reed, Inc.
(CRD # 866).**

TO THE RESPONDENT: Waddell & Reed, Inc.
 (CRD #866)
 6300 Lamar Avenue
 Overland Park, KS 66202

NOTICE OF HEARING

You are hereby notified that, pursuant to Section 11.F of the Illinois Securities Law of 1953 (815 ILCS 5/1, *et seq.*) (the "Act") and 14 Ill. Adm. Code 130, Subpart K (the "Rules"), a public hearing is scheduled to be held at 69 W. Washington, Suite 1220, Chicago, Illinois 60602, on the 20th day of December, 2005, at 10:00 a.m., or as soon thereafter as counsel may be heard, before Soula J. Spyropoulos, Esq., or another duly designated Hearing Officer of the Secretary of State.

Said hearing will be held to determine whether an Order shall be entered which would revoke Waddell & Reed, Inc.'s registration in the State of Illinois and/or granting such other relief as may be authorized under the Act including but not limited to the imposition of a monetary fine in the maximum amount pursuant to Section 11.F of the Act, payable within ten (10) business days of the entry of the Order.

The grounds for such proposed action are as follows:

A. Jurisdiction

1. Waddell & Reed, Inc. (CRD # 866) is currently, and at all times relevant to this Notice of Hearing was, registered in Illinois as a broker-dealer. Waddell & Reed also is a federal-covered investment adviser.
2. The Illinois Securities Department has jurisdiction over this matter pursuant to the Illinois Securities Law of 1953, 815 ILCS 5/1 *et seq.*
3. This action concerns the period from January 2001 through August 2002 (the "Relevant Period").

B. Background

4. Waddell & Reed, based in Overland Park, Kansas, has been a provider of financial services since 1939. It is owned by Waddell & Reed Financial, Inc., a publicly held company.
5. 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.
6. 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.
7. 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.

8. 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.
9. 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.

10. 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.
11. 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).
12. The Waddell & Reed Advisors Select Annuity issued by 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.
13. 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.
14. 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.
15. 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.)

16. 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.)

17. 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.

18. If the customer withdraws 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 the customer withdraws 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

19. 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.

20. 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.
21. 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.
22. 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, offers to policy owners the same eleven mutual fund choices that are offered by Advantage II.
23. 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).
24. 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

25. 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.
26. Waddell & Reed began discussions with Nationwide around this time.
27. 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.
28. 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 financial advisors for Nationwide. In December 2000, Waddell & Reed began selling Nationwide annuities alongside those of UILIC.
29. 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

30. 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.

31. 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.

32. 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.

33. 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.

34. 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

35. 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.
36. 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

37. 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.

38. 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 has 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.

39. 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

40. 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.

41. 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.

42. 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 needed to “secure your client base, because that’s their livelihood.” A financial advisor reported to company officials “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.”
43. 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.
44. As a result of these memoranda from the company, Waddell & Reed advisors began moving customers from UILIC to Nationwide annuities.
45. 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.
46. 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.

47. 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.

48. 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.”

49. 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.”

50. 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.

51. 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

52. 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

53. 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.

54. 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.

55. 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.

56. 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.

57. 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.

58. 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.

59. 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

60. 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.
61. 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.
62. 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

63. 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

64. Waddell & Reed has consented to the entry of an order with the NASD in which Waddell & Reed has 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, has 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 he will pay a fine of

\$150,000. Robert Williams, former national sales manager for Waddell & Reed, also has 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.

VIOLATIONS

1. Waddell & Reed failed to ensure that recommendations that customers exchange variable annuities from UILIC to Nationwide were suitable for those customers, in violation of Section 12.A of the Act.
2. Waddell & Reed engaged in dishonest or unethical practices in the exchange of customers' variable annuities from UILIC to Nationwide, in violation of Section 8.E1(b) of the Act.
3. Waddell & Reed failed reasonably to supervise its financial advisors or employees, in violation of Section 8.E1(e) of the Act.

You are further notified that you are required pursuant to Section 130.1104 of the Rules and Regulations (14 Ill. Adm. Code 130) (the "Rules"), to file an answer to the allegations outlined above within thirty (30) days of the receipt of this Notice. A failure to file an answer within the prescribed time shall be construed as an admission of the allegations contained in the Notice of hearing.

Furthermore, you may be represented by legal counsel; may present evidence; may cross-examine witnesses and otherwise participate. A failure to so appear shall constitute default, unless any Respondent has upon due notice moved for and obtained a continuance.

A copy of the Rules, promulgated under the Act and pertaining to Hearings held by the Office of the Secretary of State, Securities Department, is include with this Notice.

Delivery of Notice to the designated representative of any Respondent constitutes service upon such Respondent.

DATED: This 26th day of October, 2005.



JESSE WHITE
Secretary of State
State of Illinois

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