

STATE OF ILLINOIS
SECRETARY OF STATE
SECURITIES DEPARTMENT

IN THE MATTER OF: LPL FINANCIAL LLC, f/k/a LPL FINANCIAL)
CORPORATION.) File No. 1200385
)

NOTICE OF HEARING

TO THE RESPONDENT:

LPL Financial, LLC
c/o James Shorris, Deputy General Counsel
75 State Street, 24th Floor
Boston, MA 02109

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 "Code"), a public hearing will be held at 300 W. Jefferson Avenue, Suite 300A, Springfield, Illinois, 62702, on the 15th day of October, 2014 at the hour of 10:00 a.m. or as soon thereafter as counsel may be heard, before Jon K. Ellis or such other duly designated Hearing Officer of the Secretary of State.

Said hearing will be held to determine whether an Order should be entered against Respondent, LPL Financial, LLC, granting such relief as may be authorized under the Act, including, but not limited to, imposition of a monetary fine in the maximum amount, pursuant to Section 11.E(4) of the Act.

The grounds for such proposed action are as follows:

Summary

1. From at least 2009 to 2013, LPL Financial failed to adequately maintain certain books and records documenting its variable annuity exchange business and failed to enforce its supervisory system and procedures in connection with the documentation of certain salespersons' variable annuity exchange activities. LPL Financial's conduct constitutes cause to impose sanctions pursuant to Sections 8.E.1(e) and (q) of the Illinois Securities Law of 1953, [815 ILCS 5/1 et seq.,] (the "Act") and violates Section 12.A of the Act.

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2. Throughout the 2009 to 2013 period, LPL Financial failed to require documentation of certain variable annuity exchange transactions and certain advisors' recommendations. As a result, LPL Financial failed to identify when verification and correction of information entered in the AOE system was needed.
3. As a result of these failures, LPL Financial, in connection with certain variable annuity transactions, has not adequately enforced written supervisory procedures reasonably designed to achieve compliance with applicable securities laws and regulations and has not adequately maintained its books and records.

Registration History

4. LPL Financial is a limited liability company with a principal place of business at 75 State Street, 24th Floor, Boston, Massachusetts 02109.
5. At all times relevant hereto, LPL Financial was registered as a dealer in Illinois.
6. At all times relevant hereto, LPL Financial was registered as a broker-dealer with the Financial Industry Regulatory Authority ("FINRA") and the Securities and Exchange Commission ("SEC").
7. As a dealer registered in the State of Illinois, LPL Financial is obligated under the Act (and by the SEC and FINRA) to supervise its employees and independent contractors in order to ensure compliance with applicable Federal, State, and self-regulatory organization laws, rules, and regulations.
8. Such duties include the requirements (i) to maintain certain books and records evidencing its compliance with applicable securities laws, rules, and regulations; (ii) to create, maintain, and enforce written supervisory procedures in order to ensure compliance with applicable securities laws, rules, and regulations; and (iii) to create and test internal controls to ensure the efficacy of the written supervisory procedures.

Variable Annuity Features

9. A variable annuity is a contract, between an investor and an insurance company. The insurance company agrees to make periodic payments to the investor, beginning immediately or at some future date. The investor's capital is placed in underlying sub-account investments, such as stock, bond, and money market investments. The sub-accounts are similar to retail mutual funds.
10. Variable annuities assess a mortality and expense risk charge and there may also be administrative fees, advisory fees, and distribution fees, in addition to the sub-account expenses. Additionally, if more than a set portion of the account value is withdrawn early, the company usually assesses a surrender charge. In general, the

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surrender charge is a percentage of the amount withdrawn that declines gradually over a period of years and is a type of deferred sales charge.

11. The basic insurance benefit associated with a variable annuity is the death benefit. However, there may also be insurance benefits that can be gleaned during the investor's lifetime ("living benefits"), for a charge. Living benefits are complex and come with many limitations and conditions. Investment choices might be limited (effectively limiting the return on, and volatility of, the investment). Withdrawals may reduce the amount that otherwise would be paid under the living benefit.
12. Investors can do a tax-free exchange, or switch, of an existing annuity contract for a new annuity contract. Guarantees which have accrued might be forfeited when the existing contract is exchanged. Surrender charges payable to the Issuer will apply if the investment is being surrendered within the surrender charge period. If the new annuity has higher annual fees and charges than the old annuity, returns may be reduced, dependent on many factors including new investment choices, benefits and riders. Additionally, a new surrender charge period is typically imposed.

Variable Annuity Sales Regulation

13. FINRA and the SEC have issued numerous rules, advisory documents, and investor alerts about the sale of variable annuities, including bulletins advising investors to carefully consider the risks and costs of exchanging variable annuities.
14. A salesperson who makes a recommendation to a client is required by FINRA Rule 2330 to document the basis upon which the recommendation is made. The documentation required by FINRA Rule 2330 should provide a reviewing principal with sufficient information to assess whether the salesperson has complied with all requirements.

LPL Financial's Systems and Procedures

15. LPL Financial advisors are provided with multiple annuity research tools, including Morningstar® Annuity Intelligence™; Internal Brokerage Consultants; and the Investor Presentation & Proposal Tool.
16. All initial investment and exchange variable annuity transactions are to be submitted on the Annuity Order Entry (AOE) system for supervisor approval. The AOE system identifies transactions in the system based upon "reason codes" that may or may not indicate a need for further review.
17. LPL Financial's policies provide that when an advisor recommends the purchase or surrender of a variable annuity, all material facts are to be disclosed to the client, including fees and surrender charges. Variable annuity communications are to adhere to the following guidelines, among others.

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- a. Disclose fees and charges, including contingent deferred sales charges (also known as surrender charges), mortality and expense risk charges, administrative fees and annual contract fees.
 - b. Present complete comparisons.
 - c. Balance any discussion of liquidity with a description of the negative impacts of withdrawals.
18. The policies also provide that a detailed explanation of the underlying rationale for the suitability of the transaction and a clear financial benefit to the client, in the short- and long-term, is to be included in the transaction documentation. Furthermore, advisors are not to rely on any bonus as the justification for recommending an exchange. They are to make the client aware of all costs, expenses, and benefits associated with the replacement annuity.
19. LPL Financial's policies provide that consideration should be given to whether the financial gain or investment objective to be achieved by the switch is undermined by the transaction fees associated with the switch. The policies also provide that it is typically in the client's best interest to exchange funds within one fund family or sub-accounts within a variable annuity in order to avoid paying an additional commission or incurring additional surrender charges.

LPL Financial's Conduct

20. LPL Financial failed to identify when, in connection with certain variable annuity exchange transactions, its written supervisory procedures were not adequately enforced and its books and records were not adequately maintained.
21. The Department's investigation indicated that documentation maintained on file in connection with certain variable annuity exchange transactions and reviews of variable annuity exchange recommendations were often incomplete and/or contained inaccurate information. Certain AOE system entries reviewed by the Department contained inaccuracies, missing client information, and missing or incomplete fees for variable annuity exchange transactions. LPL Financial did not verify that information or correct it.
22. Records for several variable annuity exchange transactions identified the amount of the variable annuity being surrendered and the surrender charge as identical. For other transactions, disclosed surrender charges were inaccurate by thousands of dollars. Estimated surrender charges may vary due to market changes, but market fluctuations do not account for such substantial variance.
23. LPL Financial inadequately enforced its supervisory system and procedures in connection with the documentation of certain salespersons' variable annuity

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exchange activities. The Department's investigation indicated that supervisors were not always provided with complete and accurate documentation to ensure proper reviews of certain advisors' variable annuity exchange recommendations.

24. Advisors did not consistently document sufficient bases for their variable annuity exchange recommendations. Without enforcement of the policies, advisors failed to properly document recommendations in the AOE system, often using brief explanations which lacked sufficient information regarding the particular client's circumstances to gain approval. A Notes section was provided in the AOE system for comments and questions to facilitate the review process. However, within the AOE system, pertinent details of transactions, such as fees, options, and client objectives, were not consistently documented.
25. LPL Financial provided annuity research tools for its advisors, which would have assisted in documenting quantitative comparisons, but failed to require documentation evidencing the use of the tools. As a result, documented comparisons were generally qualitative.
26. On multiple occasions, advisors stated in the AOE system that they were unaware of the specific terms of the original annuity because they had not been the advisor at the time of the original transaction. There is no documentation indicating that the statements were addressed or that the advisors were required to obtain that information.
27. The Department notes LPL Financial's cooperation in its investigation and LPL Financial's remediation undertaken in advance of the Stipulation. LPL Financial has taken several actions in furtherance of the Department's concerns, including the termination of certain advisors who were registered as salespersons in Illinois due to their practices in connection with certain variable annuity transactions. LPL Financial also implemented the following actions, as previously described in a letter to the Department:
 - a. Undertook to offer compensation to certain LPL Financial clients who exchanged variable annuities between 2009 and 2013;
 - b. Undertook a comprehensive review of its supervisory system and procedures for variable annuity transactions, including but not limited to exchanges;
 - c. As a result of its review, made findings and conclusions regarding LPL Financial's practices, policies, and procedures, as well as recommendations for improvements and changes to such practices, policies, and procedures; and
 - d. Adopted, or is in the process of adopting, the following practices, policies, and procedures:

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- i. Creating a dedicated variable annuity review team to achieve consistent, centralized, and enhanced supervision of variable annuity transactions and documentation;
- ii. Providing enhanced training of advisors, field OSJ managers, and supervisory principals regarding the sale and exchange of variable annuities;
- iii. Implementing enhanced processes regarding: parameters for the approval of variable annuity sales and exchanges, taking into account factors such as client age and surrender charge amount; required input fields in the AOE system; independent validation of key transaction data; and review of client disclosure documents; and
- iv. Enhancing disclosures on variable annuity sales and exchange transaction documents.

Violations

28. LPL Financial's conduct in connection with certain variable annuity exchange transactions constitutes cause to impose sanctions pursuant to Sections 8.E.1(e) and (q) of the Act and violates Section 12.A of the Act.
29. Section 8.E.1(e) provides, *inter alia*, that the registration of a dealer, salesperson, or registered principal of a dealer may be suspended or revoked if the Secretary of State finds that the dealer, salesperson, or registered principal of a dealer has failed to maintain and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of its salespersons that are reasonably designed to achieve compliance with applicable securities laws and regulations.
30. Section 8.E.1(q) provides, *inter alia*, that the registration of a dealer or salesperson may be suspended or revoked if the Secretary of State finds that the dealer or salesperson has failed to maintain the books and records required under this Act.
31. LPL Financial's supervisory system and procedures for certain variable annuity exchange transactions failed to identify when verification and correction of information entered in the AOE system was needed and when reviews of certain advisors' recommendations required further documentation. LPL Financial also failed to maintain accurate and complete documentation for certain variable annuity exchange transactions.
32. By virtue of the foregoing, the Respondent's registration is subject to suspension or revocation pursuant to Sections 8.E.1(e) and (q) of the Act.

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33. Section 12.A of the Act provides, *inter alia*, that it shall be a violation of the Act for any person to offer or sell any security except in accordance with the provisions of the Act.
34. By virtue of the foregoing, the Respondent has violated Section 12.A of the Act.
35. Section 11.E(4) of the Act provides, *inter alia*, that if the Secretary of State, after finding that any provision of the Act has been violated, may impose a fine as provided by rule, regulation, or order; an order of censure; and charge all reasonable expenses as costs of investigation.
36. Section 11.F(1) of the Act provides, *inter alia*, that the Secretary of State may prohibit or suspend a dealer or salesperson from engaging in the business of selling or offering for sale securities or prohibit or suspend a person from acting as an investment adviser, federal covered investment adviser, or investment adviser representative after an opportunity for hearing is given.

You are further notified that you are required pursuant to Section 130.1104 of the Code to file an answer to the allegations outlined above or other responsive pleading within thirty (30) days of the receipt of this Notice. A failure to do so within the prescribed time shall be deemed an admission of the allegations contained in the Notice of Hearing and waives your right to a hearing.

You may be represented by legal counsel, present evidence, cross-examine witnesses and otherwise participate. However, a failure to appear shall constitute default.

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

ENTERED: This 30th day of June, 2014



JESSE WHITE
Secretary of State
State of Illinois

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