

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of

Department of Enforcement,

Complainant,

vs.

Stephen Earl Prout
Clovis, CA,

Respondent.

DECISION

Complaint No. C01990014

Dated: December 18, 2000

Registered representative entered incorrect dates of birth on variable annuity applications. Held, findings and sanctions affirmed.

We called this matter for review to determine if the sanctions were too lenient in light of the facts of this case. After a review of the entire record in this matter, we affirm the findings of the Hearing Panel that Stephen Earl Prout ("Prout") entered false dates of birth on three variable annuity applications. We affirm the Hearing Panel's sanctions of, in effect, a one-year suspension in all capacities, a \$10,000 fine, and costs.

Background

Prout entered the securities industry in 1978 as an investment company and variable contracts products representative and a direct participation program representative. In 1985, Prout became registered as a general securities principal and a general securities representative. From April 1996 to May 1998, he was registered with Titan Value Equities Group, Inc. ("Titan").

On May 15, 1998, Titan filed a Uniform Termination Notice for Securities Industry Registration, a Form U-5, disclosing that it had "discharged" Prout as of May 8, 1998, because he had violated Titan's policies and procedures by misrepresenting customers' birth dates on variable annuity applications.¹

¹ This Form U-5 was the origin of the complaint filed against Prout in this matter.

Shortly after Titan terminated him, Prout applied to and was hired by another firm (the "Firm"). Prout has been registered as a general securities principal and a general securities representative with the Firm since May 1998. Prout has been registered with the NASD for 22 years and has had no disciplinary actions taken against him.

Discussion

There is no dispute as to the salient facts surrounding Prout's violation of Conduct Rule 2110. At the hearing below, Prout admitted that he had entered false dates of birth on three variable annuity applications and he disputed none of the Hearing Panel's findings in this regard during this call for review.

At the hearing below, Prout described himself as primarily a financial planner, providing services to more than 1,000 customers, 90 percent of whom are retired senior citizens. A short time before September 1997, Prout attended a Titan sales conference where he was introduced to Pacific Mutual Life Insurance Company ("Pacific Mutual") life insurance and annuity products. After performing research about the company and its products, Prout began offering and selling Pacific Mutual variable annuities to his customers.

In 1997 and 1998, Pacific Mutual was offering a production-based promotional contest to its agents. To qualify for an all-expenses-paid trip to Hawaii, a Pacific Mutual agent was required to sell \$1.2 million worth of the company's products within a specified period.

On September 7, 1997, Prout submitted to Pacific Mutual an application for a variable annuity, with an initial purchase payment amount of \$466,000, for customer WV. On the application, Prout recorded WV's birth date as October 28, 1922. Prout knew, however, that WV's actual birth date was October 28, 1910.

On September 26, 1997, Prout submitted to Pacific Mutual a joint application for a variable annuity, with an initial purchase payment amount of \$30,000, for customers LW and MW. On the application, Prout recorded LW's birth date as November 19, 1923 and MW's birth date as April 2, 1924, when he knew that LW's actual birth date was November 19, 1913 and MW's actual birth date was April 4, 1914.

On January 20, 1998, Prout submitted to Pacific Mutual a joint application for a variable annuity, with an initial premium of \$23,500, for customers GS and RS. On the application, Prout recorded GS's birth date as June 22, 1927 and RS's birth date as November 17, 1930, when he knew that GS's actual birth date was June 22, 1917 and RS's actual birth date was November 17, 1920. Although another Titan representative, Gregory J. Weirich ("Weirich"), executed as selling agent the application for customers GS and RS, Prout admitted that Weirich played no role in falsifying their ages. Prout explained that he had allowed Weirich to sign the application because Weirich was experiencing difficulty satisfying Titan's production requirements.

Pacific Mutual offered two variable annuity products, Pacific One and Pacific Select, and paid different commissions on each product. The company paid one percent up-front plus a one percent trailing commission (payable in quarterly installments) on sales of Pacific One annuities and six percent up-front on sales of Pacific Select annuities. The Pacific One product had no contingent deferred sales charges. Prout sold Pacific One variable annuities to WV and to LW and MW. He sold a Pacific Select variable annuity to GS and RS.

On or shortly before April 26, 1998, Titan's Legal Counsel notified Prout that Pacific Mutual had learned about the falsifications and had terminated him as a Pacific Mutual agent. At Titan's request, Prout prepared a letter to explain his conduct. In his letter, Prout acknowledged that he had misrepresented the customers' dates of birth on the three annuity applications, expressed remorse, and assured Titan that he would "never again misrepresent" an applicant's age. As for his motive, Prout informed Titan that he had changed the birth dates to increase his commissions.

At the Hearing Panel hearing, Prout explained that Pacific Mutual used "age break points" in determining an agent's commissions on variable annuities. According to Prout, pursuant to Pacific Mutual's commission schedule, the company paid "full" commissions, which were calculated based on a fixed percentage of the premium payment, on contracts for annuitants who were under 75 years old. Pacific Mutual reduced the commission percentage paid, based on a sliding scale related to the age of the annuitant, on contracts for annuitants who were between 75 and 85. Prout understood that Pacific Mutual paid decreasing commissions depending upon the extent to which the annuitant was over 75 years old. He also understood that Pacific Mutual would not accept annuity contracts for individuals who were 85 or older. For each of the five individuals that Prout falsely represented was under 75 years of age, he was attempting to avoid any reduction in his commissions.

Pursuant to the stipulations of the parties and the evidence in the record, we find that Prout violated Conduct Rule 2110 when he entered false dates of birth on three variable annuity contracts. Submitting false information about customers on variable annuity applications is a violation of the NASD's just and equitable principles of trade rule. See In re Donald Clyde Bozzi, 1999 NASD Discip. LEXIS 5 (NAC Jan. 13, 1999).

In addition to the facts establishing a rule violation, the Hearing Panel explored a few important additional issues at the hearing. In Prout's April 1998 letter to the Legal Counsel for Titan, Prout admitted that he was fully responsible for giving false dates of birth on the variable annuity applications. He also stated: "The only reason for changing the ages was for commission purposes." (Emphasis added.) At the hearing, however, Prout testified that when he submitted the applications for WV and for LW and MW, he was seeking to qualify for Pacific Mutual's Hawaii trip. Prout further admitted that because WV was actually over 85 years old, by falsifying WV's date of birth, Prout had induced Pacific Mutual to accept an application that it probably would have rejected. The Hearing Panel concluded that Prout's letter to Titan was misleading because it mentioned only commissions as his motivation and did not mention the Hawaii trip.

The Hearing Panel also explored the accuracy of Prout's repayment of commissions to Titan and Pacific Mutual. At Titan's request, on May 7, 1998, Prout issued a check to Titan for \$230 as repayment of commissions for the three variable annuities involved in this case. At the hearing below, Prout testified that he had accepted Titan's figure of \$230 as the correct amount of commissions without checking his own records. In response to questions raised by the Hearing Panel, Prout reviewed his records to verify whether this calculation was accurate. Approximately three weeks after the hearing, Prout issued a second check to Titan for \$934.97, which represented the balance of all commissions he received from Pacific Mutual for the three variable annuities.²

Firm-Imposed Suspension for Prout

Approximately 15 months after the Firm hired Prout, the Department of Enforcement ("Enforcement") filed the complaint against Prout in this matter. Prompted by Enforcement's action, the Firm imposed a three-month suspension on Prout from engaging or participating in the offer or sale of securities. During this three-month period, Prout did not conduct any mutual fund, variable annuity, or other securities business for the Firm, and he only engaged in activities related to fixed annuity and other non-securities products. Prout was not, however, suspended from acting as a principal of the Firm.

The question for our consideration is what weight, if any, to give to the fact that the Firm imposed a suspension on Prout for three months in 1999. The Hearing Panel gave Prout credit for the three-month suspension that the Firm imposed. We affirm this determination. We generally encourage firms to take the initiative, investigate and evaluate an episode of misconduct, and -- in appropriate instances -- impose a suspension on an employee. Under the specific circumstances of this case, we find the following facts important in awarding credit for the suspension imposed on Prout by his Firm:³

1. The Firm properly documented the starting and ending dates of the suspension and the reason for the suspension.⁴ Prout's suspension was documented in a letter from the President of the Firm to Prout.

² This amount included \$526.88 that Pacific Mutual had paid to Weirich as the agent on the GS and RS annuity. Weirich had previously paid this commission to Prout.

³ We note that all of the facts that we consider important may be the subject of dispute in a case. In such a situation, we rely on the Hearing Panel to assess the credibility of claims by a respondent or by Enforcement that a particular aspect of a firm-imposed suspension happened as claimed. See In re Jonathan Garrett Ornstein, 51 S.E.C. 135, 137 (1992). We also note that other facts may be important in other cases. In this case, for example, Prout was not associated with any other firm during his suspension.

⁴ When any firm takes disciplinary action against an associated person that includes a suspension, this event is reportable under Conduct Rule 3070(a)(10).

2. The Firm imposed its suspension promptly. Here, the Firm suspended Prout shortly after the Firm learned that Enforcement had filed a complaint against Prout. There was no indication that the Firm adjusted the timing of its suspension for the convenience of the respondent.

3. The Firm imposed the suspension for regulatory purposes. If a firm suspends a registered representative for its own business reasons, we will not give credit for that suspension. For example, a firm that suspends a registered representative for failing to meet production goals is not suspending that person for NASD regulatory reasons such as investor protection or high standards of commercial honor. In Prout's case, the Firm's purpose in suspending him was the same regulatory purpose as the NASD's.

4. Whether the firm-imposed suspension was in all capacities or only certain capacities. As discussed above, the Firm suspended Prout only as a general securities representative.

In this case, we give Prout credit for the Firm's three-month suspension of him. The suspension was properly documented. The suspension occurred shortly after the Department of Enforcement filed its complaint against Prout, and the Firm's purpose was to prevent Prout from engaging in such misconduct in the future. While the Firm did not suspend Prout in all capacities, in this case we do not find that the suspension of Prout only as a general securities representative was so limited as to negate the remedial value of the suspension.

Sanctions

Prout argued below that he should not be sanctioned because he had already been terminated by Titan and Pacific Mutual. We affirm without qualification the Hearing Panel's conclusion that Prout should receive no credit for the fact that Titan and Pacific Mutual terminated him for his misconduct. As a general matter, we give no weight to the fact that a respondent was terminated by a firm when determining the appropriate sanction in a disciplinary case. We consider the disciplinary sanctions we impose to be independent of a firm's decisions to terminate or retain an employee. We neither credit a respondent who was terminated by a firm, nor seek additional remedies against a respondent who was retained by a firm. Consequently, we award Prout no credit for the fact that he was terminated by Titan and Pacific Mutual.

Turning to the appropriate remedy for Prout's recording of false information on variable annuity contracts, we take guidance from the NASD Sanction Guidelines ("Guidelines") regarding forgery or falsification of records.⁵ The Guideline states that "[i]n cases where mitigating factors exist, consider suspending respondent in any or all capacities for up to two years. In egregious cases, consider a bar." We also have consulted the principal considerations section of the Guidelines, and we find the following considerations applicable:

⁵ See Guidelines (1998 ed.) at 35 (Forgery And/Or Falsification Of Records).

As to the frequency and duration of Prout's misconduct, he falsely recorded five different dates of birth over a period of four months. See Guidelines at 8. Although each false date of birth was a serious misrepresentation by Prout to Pacific Mutual we do not conclude, given Prout's admission of his errors and his expression of remorse, that he has demonstrated a pattern of providing false information on annuity applications.

As to the related concepts of Prout's accepting responsibility for and acknowledging his misconduct to Titan and providing substantial assistance to NASD Regulation in its investigation, we have considered Prout's assistance to NASD Regulation. The second principal consideration in the Guidelines requires that a respondent have accepted responsibility for and acknowledged the misconduct to his employer prior to detection and intervention by the firm or a regulator. Prout does not qualify for a favorable determination of this consideration because his acceptance of responsibility to Titan came only after Pacific Mutual terminated Prout. Prout did, however, provide some assistance to NASD Regulation because he admitted that he entered false dates of birth on the variable annuity applications. See Guidelines at 9.

Principal consideration number seven asks whether the respondent's conduct injured the investing public. Id. Prout testified on this issue as follows: Before submitting any of the applications, Prout ascertained by questioning employees at several insurance companies, including Pacific Mutual, that there would be no adverse ramifications either to an annuitant or his potential beneficiaries if the annuitant's age was misstated on an annuity application. Based on his inquiries, Prout understood that Pacific Mutual (and other annuity companies) reduced the commission percentage paid on contracts for annuitants who were over 75 solely for their own economic reasons, i.e., so that they could -- on average -- recoup the commission load by the time of the annuitants' death.

At the hearing below, Prout explained that he had been able to "rationalize" falsifying the customers' dates of birth because Pacific Mutual "would really never miss [the excess commissions] and even upon death there wouldn't be any negative [impact] to the beneficiaries or survivors." Prout, however, never ascertained whether there would be any negative impact if the misstatement of the annuitant's age caused a company to accept a contract application that it otherwise would not have accepted, as was the case for the annuity application Prout submitted for WV.⁶

The Hearing Panel accepted Prout's claim and concluded that "Prout's misconduct did not result in harm to the investing public." We disagree with this conclusion. The question we focus on is: Did Prout's misconduct cause harm or threaten harm to the investing public? Here, Pacific Mutual discovered Prout's misconduct and chose, for its own reasons, to confirm the annuity contracts with the customers. The severity of Prout's misconduct is not lessened because of Pacific Mutual's actions. We find that Prout's falsifications did threaten to harm his customers. In the event that Pacific Mutual did not detect the false dates of birth and if any of Prout's customers had decided to convert their annuities from

⁶ In this case, after learning of the true ages of the applicants, Pacific Mutual did not cancel any of the three variable annuities.

the accumulation phase to the payout phase, or "annuitize" their contracts,⁷ the amount of annual payment to the beneficiary would have been less than if Pacific Mutual had used the correct age for the annuitant. Moreover, if Prout's customers had experienced substantial declines in their investment accounts and if those customers then died, the beneficiaries would have faced a risk that Pacific Mutual would have resisted paying a death benefit of the total purchase payments for the annuity. Because of the false date of birth on the application, Pacific Mutual might have paid the beneficiaries only the market value of the annuity's investment accounts.

Principal consideration number 17 asks whether the respondent's misconduct resulted in the potential for respondent's monetary or other gain. Here, Prout's motives were to win a trip to Hawaii and increase his commissions. We have considered Prout's willingness to deceive an annuity company for his personal gain in determining our sanctions.

We have also considered the fact that Prout repaid to Titan and Pacific Mutual the commissions that he received. The value that we give to this action is lessened because Prout did not accurately calculate the correct amount of the repayment until prompted to do so by the Hearing Panel. Finally, we agree with the Hearing Panel that Prout has expressed genuine remorse for his violation of the NASD's rules.

Taking into consideration that we have awarded Prout credit for his Firm's three-month suspension, we view his total suspension to be equivalent to one year. We impose a one-year suspension along with a \$10,000 fine on Prout to impress upon him and others the seriousness of his misconduct.⁸ Although we have found certain circumstances of Prout's misconduct aggravating, we do not conclude that his violation was an egregious case of falsification of documents. Therefore, we do not impose a bar in this case.⁹ We conclude that Prout made a serious mistake in judgment, but that the appropriate remedy is a lengthy suspension.

⁷ We use the term "accumulation phase" to refer to the period of time beginning after the variable annuity contract has been issued by the variable annuity company and ending when annuity payments begin. Typically, annuitants are contributing additional funds to their variable annuity during the accumulation phase. By "payout phase," or annuity period, we refer to the period of time during which annuity payments are made. Annuitization or annuitizing a variable annuity is the action resulting from an annuitant's decision to start receiving annuity payments.

⁸ We have considered Prout's request at oral argument that we eliminate his fine and suspend him for a longer period of time. In this case, we conclude that both a \$10,000 fine and a suspension are required in order to impress upon Prout and others the gravity of Prout's misconduct.

⁹ Because we have found mitigating factors in this case, we follow the recommendation of the Guidelines that "in cases where mitigating factors exist, consider suspending respondent in any or all capacities for up to two years." Guidelines at 35.

Accordingly, Prout is suspended from associating with any NASD member in any capacity for one year (which we reduce by three months), fined \$10,000 and ordered to pay \$1,497.25 in costs for the Hearing Panel's hearing.¹⁰

On Behalf of the National Adjudicatory Council,

Joan C. Conley,
Senior Vice President and Corporate Secretary

¹⁰ We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

Pursuant to NASD Procedure Rule 8320, any member who fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanctions, after seven day's notice in writing, will summarily be revoked for non-payment.