

**Department of Commerce and Insurance**

**Review of Inaction on the Part of Insurance Division  
Employees Involved in the Regulation of  
Franklin American Life Insurance Company**

**July 2000**

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July 7, 2000

The Honorable Don Sundquist, Governor  
and  
Members of the General Assembly  
State Capitol  
Nashville, Tennessee 37243  
and

The Honorable Anne Pope, Commissioner  
Department of Commerce and Insurance  
Davy Crockett Tower  
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Ladies and Gentlemen:

Transmitted herewith is a special report on the Division of State Audit's review of inaction on the part of employees of the Department of Commerce and Insurance, Insurance Division, responsible for the regulation of Franklin American Life Insurance Company. This review was initiated in July 1999 after information was received by this office from State of Tennessee officials and the national news media. In May 1999, it was reported in the news media that Mr. Martin R. Frankel, an unlicensed securities broker from Greenwich, Connecticut, had disappeared after allegedly stealing \$200 million in funds of Franklin American Life Insurance Company and other related corporate entities. These companies invested their reserves with Liberty National Securities, Inc., a brokerage firm he anonymously controlled. The information received by the Division of State Audit alleged that prior to May 1999, state regulators within the Tennessee Department of Commerce and Insurance failed to appropriately react to significant warning signs and information available to them regarding Franklin American Life Insurance Company and Liberty National Securities, Inc. It was also alleged that the department gave special treatment to the company, in light of relationships between the company, a former department Commissioner, and a former analyst with the department.

Business entities that provide insurance services are governed and regulated by the individual states in which the insurance provider conducts business. The Tennessee Department of Commerce and Insurance, Division of Insurance, has two general methods for identifying and monitoring financially troubled insurers. Division staff perform on-site examinations of those insurance companies headquartered in Tennessee (domestic insurers) to verify the accuracy of their financial statements. Division staff also conduct desk examinations of quarterly and annual unaudited financial statements and annual audited financial statements of the insurance companies doing business in Tennessee. During desk examinations, division staff analyze financial data using ratios specifically intended to identify deficiencies in reserves and liquidity, and to discover emerging trends in revenue and expenses.

The review determined that regulators within the Department of Commerce and Insurance performed these types of examinations of Franklin American Life Insurance Company on a reasonably timely basis. However, because department staff failed to exercise sufficient professional skepticism, conducted inadequate procedures and review, and misapplied procedures, these regulatory activities failed to detect the fraudulent nature of Mr. Frankel's activities before May 1999. The department's gross breakdown in its regulation of Franklin American Life Insurance Company occurred despite significant warning signs of questionable activities. Furthermore, there was a lack of communication between insurance division staff and other department officials.

In 1986, when the company known as Franklin American Life Insurance Company was established, it did not appear to be significantly different in organization or operations from most other insurance companies regulated by the department. In August 1991, the company was placed under administrative supervision due to insufficient capital and surplus. In the later part of 1991, Franklin American Life Insurance Company was acquired by Thunor Trust. The acquisition of Franklin American Life Insurance Company by the trust appeared to rescue the insurance company, even though department staff realized that it was unusual for a trust to acquire an insurance company. Furthermore, the trust was unusually structured in that it was an irrevocable trust agreement that placed the control of the acquisition funds and the operation of Franklin American Life Insurance Company exclusively with a sole trustee. From this point on, Franklin American Life Insurance Company began to present unusual circumstances for the department to consider.

Faced with the apparent good faith efforts of the representatives of the trust to salvage the struggling insurance company, department regulators approved the acquisition. At that time, the department followed its general philosophy that it was in the best interests of the state to allow new management to run the operations of financially troubled insurance companies rather than for the department to take over the operations in a rehabilitation or to liquidate such companies. In addition, the department took the approach that even though the acquisition was unusual, unless there were laws, regulations, or policies which would clearly prohibit such an acquisition, it did not have the authority to deny the request for the acquisition.

In light of Franklin American Life Insurance Company's poor financial condition at the time of the acquisition, the department, pursuant to its rules, required the company to submit its financial statements on a monthly basis, rather than quarterly, for the purposes of monitoring its financial transactions.

Notwithstanding this initial extra oversight, throughout its remaining dealings with Franklin American Life Insurance Company, department staff and officials continued to regulate the company using the routine basic approaches noted above. Over the seven and a half years that the department regulated Franklin American Life Insurance Company before the company ceased operations in May 1999, department staff and officials had several opportunities to take more aggressive action against the company. However, many of these situations involved unusual transactions or business operations that were confusing and not easily understood. If staff had exercised reasonable skepticism in trying to understand these matters, the fraudulent nature of the activities would have become apparent.

But instead of demanding explanations or trying to understand the company's representations, department staff and officials reacted to these issues by deciding that even though the circumstances appeared unusual, unless there was a law, regulation, or policy that was clearly violated, they could take no action. Furthermore, even when faced with a clear violation of a department rule, as was the case due to the company's failure to maintain assets with an independent custodian, the department waited nearly two years to take action (from 1997 to the later part of 1998). This delay continued, despite recommendations from division analysts that an expert should review the company's unusual and seemingly excessive trading of government securities. The department's inaction in regard to this violation was due to the apparent lack of staff and funding; the nonavailability of the contract examiner who eventually conducted the last examination of the company; the apparent desire to assist the company in its efforts to survive; and a very narrow reading of the rules, all of which served to diminish the extent and effectiveness of regulatory activities.

Despite the department's failures, it should be noted that because the department eventually required Franklin American Life Insurance Company officials to place the company's cash reserves in a custodian bank, as required by department rules, Tennessee was able to recover approximately \$57 million of the company's funds allegedly entrusted with Liberty National Securities, Inc., when other states with related corporate entities did not. Under the compromise and settlement with the four other states involved, the State of Tennessee Commissioner tendered \$17.5 million to the out-of-state receivers. Therefore, the net recovery, to this point, is approximately \$40 million of the company's funds, out of the approximately \$69 million in alleged total assets.

The review did not find that any of the inadequacies noted above were intentional on the part of the department staff. In addition, this review did not substantiate the allegations that Franklin American Life Insurance Company was given any special treatment by the department.

The review did find that even when staff correctly followed procedures, and information was appropriately shared between the Insurance Division and the Securities Division, such information was not used by department officials in their decision making regarding the regulation of Franklin American Life Insurance Company. As pointed out by a contract examiner, the company was not in compliance with the department rules requiring a custodial agreement with a bank for the holding of the company's securities. In late December 1998, based on a request by the department, the company allegedly liquidated its holdings with Liberty National Securities, Inc., and deposited cash into a bank. Without the knowledge or approval of the department, company representatives withdrew the cash and transferred it back to Liberty National Securities, Inc., in the middle of January 1999. Soon afterwards, individuals representing Franklin American Life Insurance Company began meeting with department personnel in efforts to allow the company to use the services of Liberty National Securities, Inc., as before.

In the later part of January 1999, the contract examiner visited the department's securities division and gathered information on Liberty National Securities, Inc. The information the contract examiner obtained regarding the brokerage firm was inconsistent with the statements and assertions of the officials with Franklin American Life Insurance Company. This discovery presented critical questions about the relationship between the company and the brokerage firm. Specifically, the contract examiner found that Liberty National Securities, Inc., had less than \$60,000 net worth, and the firm's registration made no mention of a New York City address or that the firm was trading in government securities. The contract examiner concluded that it was possible that the brokerage firm was just a front and that Franklin American Life Insurance Company had been looted of its assets invested with Liberty National Securities, Inc. This critical information was shared with the insurance division staff, but apparently the then Commissioner and department legal staff were not apprised of these disturbing facts.

Following a February 2, 1999, meeting between Franklin American Life Insurance Company representatives and department officials, the then Commissioner decided to allow the company to resume the trading of its assets with Liberty National Securities, Inc., for an additional 60 days. Although this decision was contrary to department rules, which required a custodial agreement with a bank for the holding of insurance company securities, in the Commissioner's opinion, it gave Franklin American Life Insurance Company a reasonable period in which to comply with the rule. However, this decision was made without the full facts and information available at the time. The decision-makers were apparently not aware of the serious concerns held by the insurance division chief examiner and the contract examiner regarding the brokerage firm, Liberty National Securities. In addition, the insurance division staff stated they were silent about these concerns because the insurance procedures did not address inconsistent information regarding a brokerage firm and its registration and, in part, because it was their opinion that fraud involving the funds thought to be invested with Liberty National Securities, Inc., was no longer an issue since company officials had been able to present the funds in question and had deposited them in a banking institution.

Unbeknownst to the department, during early 1999, the company's funds allegedly invested with Liberty National Securities, Inc., were actually in a Swiss bank account controlled by Mr. Frankel. Presently available information indicates that the reported trades of government securities on behalf of Franklin American Life Insurance Company did not actually occur. The brokerage firm's statements and other documents related to the trades were apparently bogus. These alleged activities of Mr. Frankel resulted in false financial information in Franklin American Life Insurance Company's financial statements that were prepared based on the brokerage firm's alleged trades. The inclusion of the false trading information and reported gains from these trades in the financial statements of Franklin American Life Insurance Company gave the appearance that the insurance company was financially sound when, in fact, it was not.

However, in keeping with the then Commissioner's demand to have either a custodial agreement with a bank in place or for the company to return the funds to a bank after the 60-day period, Mr. Frankel moved \$57 million from his Swiss bank account to Prudential Savings Bank on April 8, 1999. When Mississippi officials requested that the funds of related corporate entities in Mississippi be placed in a banking institution in late April 1999, Mr. Frankel was unable or unwilling to produce those additional funds, also purported to be invested with Liberty National Securities, Inc. On May 5, 1999, a fire occurred at Mr. Frankel's residence in Greenwich, Connecticut, and it became known that Mr. Frankel had fled the country. On September 4, 1999, Mr. Frankel was taken into custody in Hamburg, Germany, and is fighting extradition to the United States.

The department's misapplication of procedures, insufficient professional skepticism, inadequate procedures, and lack of communication all contributed to the failure to detect Mr. Frankel's fraudulent activities. Those failures in the regulatory process of Franklin American Life Insurance Company are summarized in chronological order below:

- In 1991, the department approved the acquisition of Franklin American Life Insurance Company by Thunor Trust without questioning the oddities of the transaction, such as the irrevocable designation of a sole trustee, and the designation and subsequent removal of a sole beneficiary.
- In 1993, the insurance division examiners failed to note the improper holding of the company's securities by Liberty National Securities, Inc., and accepted the brokerage firm's confirmation of the company's assets without question.
- In 1993 and 1994, the insurance division staff failed to investigate the unusual volume of trading of securities and unusual returns on investments reported by the company.

- In 1995 and 1996, the insurance division staff failed to properly note that the company's disclosure forms revealed that its investments were improperly held by a brokerage firm without an independent custodial agreement, which is required by the department's rules.
- In 1996, the insurance division staff conducted a "target examination" of the company's trading activities. Because the analysts involved in this examination were not securities experts, the examination was discontinued without determining the full extent of the company's trading activities. None of the analysts' work was documented as required by department policies and procedures.
- From 1996 through 1998, the Financial Affairs Director of the insurance division was lax in taking action against the company even though analysts continually recommended action.
- In 1999, despite warning signs regarding the viability of Liberty National Securities, Inc., the then Commissioner, apparently unapprised of the warning signs, decided to allow the company to resume the trading of its assets with Liberty National Securities, Inc., although the company did not have a required custodial agreement in place.

Although a significant portion of the funds of Franklin American Life Insurance Company's policyholders was recovered, largely due to the ultimate enforcement of the department's rules requiring custodial agreements with banking institutions, the lack of action on the part of state regulators could have resulted in a far worse outcome. The following report details the weaknesses in the insurance company regulatory process as it relates to Franklin American Life Insurance Company. The report also details the measures developed by the newly appointed Commissioner and her staff to address these weaknesses to detect similar fraudulent activity in the future.

Sincerely,



John G. Morgan  
Comptroller of the Treasury

State of Tennessee

# Audit Highlights

Comptroller of the Treasury

Division of State Audit

Special Report

**Department of Commerce and Insurance  
Review of Inaction on the Part of Insurance Division Employees  
Involved in the Regulation of  
Franklin American Life Insurance Company**

July 2000

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## **REVIEW OBJECTIVES**

The objectives of the review were to determine whether the department was in compliance with state statutes and national regulations and guidelines in the examinations and financial analyses of Franklin American Life Insurance Company; to determine whether the department followed state and federal statutes in regard to the approval of the acquisitions of the company and Franklin American Corporation by Thunor Trust; to determine whether reasonable actions were taken on the part of department officials in the regulation of the company; to evaluate whether the department gave special treatment to the company; to identify any weaknesses in the department's internal controls over the examinations and analyses of Franklin American Life Insurance Company; to report our findings to the department and recommend appropriate actions to correct any deficiencies; and to report our findings to the Office of the State Attorney General, the United States General Accounting Office (GAO), the Federal Bureau of Investigation (FBI), and the general public.

## **RESULTS OF THE REVIEW**

This review was initiated in July 1999 after information was received by this office from State of Tennessee officials and the national news media. Beginning in May 1999, it was reported in the news media that Mr. Martin R. Frankel, an unlicensed securities broker from Greenwich, Connecticut, had disappeared after allegedly stealing \$200 million in funds of Franklin American Life Insurance Company and other related corporate entities in the United States that also invested their reserves with Liberty National Securities, Inc., the brokerage firm he anonymously controlled. The information the Division of State Audit received alleged that the state regulators within the Tennessee Department of Commerce and Insurance failed to appropriately react to significant warning signs and information available to them regarding Franklin American Life Insurance Company and Liberty National Securities, Inc., prior to May 1999 that should have revealed the apparent fraudulent activities of Mr. Frankel. It was also alleged that the department gave special treatment to the company, in light of relationships between the company, a former department Commissioner, and a former analyst with the department.

This review determined that regulators within the Department of Commerce and Insurance failed to detect the fraudulent nature of Mr. Frankel's activities before May 1999 because department staff failed to exercise sufficient professional skepticism, conducted inadequate procedures and review, and misapplied procedures. The department's gross breakdown in its regulation of Franklin American Life Insurance Company occurred despite significant warning signs of questionable activities. Furthermore, there was a lack of communication between the insurance division staff and other department officials.

Throughout all of its dealings with Franklin American Life Insurance Company, department staff and officials were presented with unusual circumstances. The department took the approach that even though circumstances were unusual, unless there were laws, regulations, or policies which clearly would prohibit transactions on the part of the company, the department did not have the authority to act. Over the seven and a half years that the department regulated Franklin American Life Insurance Company before the company ceased operations in May 1999, department staff and officials had several opportunities to take more aggressive action against the company. However, many of these situations involved unusual transactions or business operations that were confusing and not easily understood. If staff had exercised reasonable skepticism in trying to understand these matters, the fraudulent nature of the activities would have become apparent. But instead of demanding explanations or trying to understand the company's representations, department staff and officials reacted to these issues by deciding that even though the circumstances appeared unusual, unless there was a law, regulation, or policy that was clearly violated, they could take no action.

The review determined that the department staff failed in its regulatory functions regarding Franklin American Life Insurance Company, but the review did not find that any of the inadequacies noted above were intentional on the part of the department staff. In addition, this review did not substantiate the allegations that Franklin American Life Insurance Company was given any special treatment by the department.

The review determined that the department was in compliance with state statutes regarding the filing of all required documents in relationship to the acquisition of Franklin American Life Insurance Company and its holding company by Thunor Trust. However, the department approved the acquisition without fully understanding and questioning the oddities of the transaction.

Furthermore, weaknesses in the internal controls in the regulation of insurance companies, mainly involving the insurance division, were noted and discussed with management of the department. On June 20, 2000, the department responded to these issues by concurring with the findings and recommendations and stating its corrective actions taken.

On May 5, 2000, our office submitted information regarding this matter to the Office of the State Attorney General, the United States General Accounting Office (GAO), the Federal Bureau of Investigation (FBI), and the Tennessee Department of Commerce and Insurance.

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"Audit Highlights" is a summary of the special report. To obtain the complete special report, please contact

Comptroller of the Treasury, Division of State Audit  
1500 James K. Polk Building, Nashville, TN 37243-0264  
(615) 741-3697

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**Department of Commerce and Insurance**  
**Review of Inaction on the Part of Insurance Division Employees**  
**Involved in the Regulation of**  
**Franklin American Life Insurance Company**  
**July 2000**

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**Department of Commerce and Insurance**  
**Review of Inaction on the Part of Insurance Division Employees**  
**Involved in the Regulation of**  
**Franklin American Life Insurance Company**  
**July 2000**

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**INTRODUCTION**

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**ORIGIN OF THE REVIEW**

This review of inaction and alleged special treatment on the part of insurance division employees involved in the regulation of Franklin American Life Insurance Company was initiated in July 1999 after information was received by this office from State of Tennessee officials and the national news media via the *New York Times* and the *Wall Street Journal*. At that time, state and federal officials had already initiated an investigation into the activities of Mr. Martin R. Frankel, an unlicensed securities broker from Greenwich, Connecticut. The state and federal investigations began in May 1999, after the Greenwich fire and police departments were dispatched to a fire alarm reported at 889 Lake Avenue, the residence of Mr. Frankel, on May 5, 1999. At the residence, the police recovered records involving numerous business entities engaged in apparent fraudulent securities trading allegedly operated at the direction of Mr. Frankel, using several aliases. According to the October 1999 36-count federal indictment returned against Mr. Frankel, he had anonymously controlled various entities, including Thunor Trust (a trust allegedly created by Mr. Frankel which acquired Franklin American Life Insurance Company and its holding company, Franklin American Corporation, both of Franklin, Tennessee) and Liberty National Securities, Inc. (the brokerage firm entrusted with investing the reserves of Franklin American Life Insurance Company). The indictment alleges that by gaining control of Franklin American Life Insurance Company and other insurance companies in the United States, Mr. Frankel was able to improperly access and control the cash reserves of the companies. The indictment further alleges that Mr. Frankel embezzled in excess of \$200 million from these cash reserves for his and others' benefit.

The information the Division of State Audit received alleged that the state regulators within the Tennessee Department of Commerce and Insurance failed to appropriately react to significant warning signs and information available to them regarding Franklin American Life Insurance Company and Liberty National Securities, Inc., prior to May 1999. Appropriate reaction on the part of state regulators should have revealed the apparent fraudulent activities of Mr. Frankel. The allegations extend as far back in time as September 1991, relative to the department's handling of the acquisition of Franklin American Life Insurance Company and its holding company, Franklin American Corporation, by Thunor Trust, allegedly created by Mr. Frankel. The allegations also included the apparent inaction on the part of state regulators after "unusual" trading activities were disclosed in the company's financial records year after

year. It was alleged that state regulators either failed to enforce regulations that required the investments of Franklin American Life Insurance Company to be held with a bank with a custodial agreement in place or afforded the company special treatment, possibly because of political ties.

In addition, it was speculated that department regulators may have given special treatment to Franklin American Life Insurance Company, in light of relationships between former department employees and the company. The speculation of special treatment extends back in time as far as August 1991, when the department placed Franklin American Life Insurance Company on “administrative supervision” rather than taking the more harsh action of placing the company into receivership and taking control of operations because of the company’s insufficient capital and surplus reserves.

Furthermore, it was also speculated that a department analyst might have given special treatment to Franklin American Life Insurance Company during his analysis of the company’s financial statements in 1996, before the analyst accepted a job with the company.

The total amount of funds allegedly embezzled by Mr. Frankel is unknown at this point but has been estimated to be approximately \$200 million. The funds involved did not include state funds but were made up of policyholder premiums and stockholder invested funds.

## **OBJECTIVES OF THE REVIEW**

The objectives of the review were

1. to determine whether the department was in compliance with state statutes and national regulations and guidelines in the examinations and financial analyses of Franklin American Life Insurance Company;
2. to determine whether the department followed state and federal statutes in regard to the approval of the acquisitions of the company and Franklin American Corporation by Thunor Trust;
3. to determine whether reasonable actions were taken on the part of department officials in the regulation of the company;
4. to evaluate whether the department gave special treatment to the company;
5. to identify any weaknesses in the department’s internal controls over the examinations and analyses of Franklin American Life Insurance Company;
6. to report our findings to the department and recommend appropriate actions to correct any deficiencies; and

7. to report our findings to the Office of the State Attorney General, the United States General Accounting Office (GAO), the Federal Bureau of Investigation (FBI), and the general public.

## **SCOPE OF THE REVIEW**

On July 2, 1999, Division of State Audit staff took possession of original documents relating to Franklin American Life Insurance Company, Franklin American Corporation, Thunor Trust, and Liberty National Securities, Inc., maintained by the Department of Commerce and Insurance. Copies of the documents in possession of the department's legal staff were subsequently obtained. Our review included an examination of the department's documents. We also interviewed current and former staff of the department's insurance division, securities division, legal office, and the Commissioner's office.

## **BACKGROUND**

### Regulation of Insurance Companies in Tennessee

Business entities such as Franklin American Life Insurance Company, which provide insurance services, are governed and regulated by the states in which the insurance providers conduct business. Each state is responsible for establishing relevant laws and regulations for licensing insurers, regulating their operations, monitoring insurer solvency, and ensuring a safe and sound marketplace so that legitimate policyholder claims are paid and consumers are treated fairly and equitably. States are also responsible for rehabilitating and liquidating impaired or insolvent insurers (*Regulation of Insurance Company Solvency*, National State Auditors Association Joint Audit Project, June 1992). Generally, an insurance provider maintains, and is required by the states to maintain, a significant portion of its assets in reserves. These reserves often consist of insurance policy premiums collected from policyholders. Regulations governing insurance providers often require that reserves are safely held or invested and generally available for the payment of claims made by policyholders.

The Tennessee Department of Commerce and Insurance, Division of Insurance, has two general methods for identifying and monitoring financially troubled insurers. The division staff, or contracted individuals, perform on-site examinations of those insurance companies headquartered in Tennessee (domestic insurers) to verify the accuracy of their financial statements. These examinations were performed every three years for domestic insurers, such as Franklin American Life Insurance Company, until approximately 1995, when the department changed its examinations to a five-year cycle. During the on-site examinations, a company's reserves are verified with the various banking institutions actually holding the funds. The division staff also conduct desk examinations of quarterly unaudited financial statements and annual CPA-audited financial statements of the insurance companies. During these desk examinations,

division staff analyze the financial data through ratios specifically targeted to identify deficiencies in reserves and liquidity, and to identify emerging trends. The desk examinations are also targeted to identify noncompliance in areas such as whether the company had physical control of its stocks, bonds, and other securities. The issue of the physical control over securities was a key element in the alleged embezzlement of assets by Mr. Frankel and likewise a key element in the regulation process.

States are assisted in their regulatory efforts by the National Association of Insurance Commissioners (NAIC), a voluntary organization of state regulators. NAIC's main function is to coordinate state insurance regulatory information and activities. NAIC collects financial data on thousands of insurers operating in the United States and performs ratio analyses with this information. The Tennessee Department of Commerce and Insurance receives an annual analysis from NAIC for those insurers domiciled in Tennessee. Insurers are asked to supply the department with explanations for those ratios, which are outside specified standards. NAIC has also promulgated regulatory guidelines that were adopted by the department in 1994.

The department can apply varying degrees of sanctions when an insurer's financial condition is problematic. The Commissioner can place an insurer in administrative supervision if the Commissioner determines that the insurer's condition renders the continuance of its business hazardous to its shareholders, creditors, or the public, or it appears that the business of the insurer is being conducted fraudulently. After being notified, the insurer is furnished with a written list of requirements to abate the determination and given 60 days to comply with these requirements. Under administrative supervision, management maintains control of the company; however, certain transactions may require approval from the department. The Commissioner may also apply by petition to the chancery court of Davidson County (Nashville, Tennessee) for an order authorizing the Commissioner to rehabilitate or to liquidate a domestic insurer. In rehabilitation, the department would operate the insurer until the financial problems are resolved. In liquidation, the department settles all the affairs of the insurer and the insurance company's operations are terminated.

On May 11, 1999, Franklin American Life Insurance Company was placed under voluntary rehabilitation pursuant to *Tennessee Code Annotated*, Sections 56-9-101 and 56-9-303. This petition was sought because Mr. Frankel's alleged fraudulent activities, including the embezzlement of invested reserve funds from the brokerage firm he controlled, had become apparent.

#### *The Scheme (1991-1997)*

State and federal investigations are currently ongoing, and many of the details surrounding the alleged fraudulent activities of Mr. Frankel have already been publicized. Although this review did not involve investigating Mr. Frankel's activities, a general understanding of his activities is necessary to provide perspective in relation to the actions of the State of Tennessee regulators within the Department of Commerce and Insurance until the rehabilitation order filed May 11, 1999.

According to the 36-count federal indictment filed on October 7, 1999, the Thunor Trust of Tennessee was established in September 1991 at the direction of Mr. Frankel. Mr. John A. Hackney, a Lawrenceburg, Tennessee, native, was named as the sole trustee of Thunor Trust. The extent of Mr. Hackney's involvement in Mr. Frankel's fraudulent activities, if any, is unknown to the Division of State Audit. (Though an investigation into the matter is ongoing, the auditors did not have access to the investigative findings.) Furthermore, Mr. Hackney's attorney, Mr. Jim Sanders with the Nashville, Tennessee law firm of Neal and Harwell, was contacted and an interview with Mr. Hackney was declined.

The stated purpose of the trust was "to purchase Franklin American Corporation and other related corporations and to enter into such other investments, as the trustee deems advisable." The trust gave the trustee the specific right to invest any cash assets at any financial institution. Thunor Trust purchased a majority of Franklin American Life Insurance Company's stock in September 1991. The Department of Commerce and Insurance approved the \$3.75 million acquisition of Franklin American Life Insurance Company and its holding company (Franklin American Corporation) on October 7, 1991. At the time of the acquisition, Franklin American Life Insurance Company had approximately \$24 million in assets and \$22 million in liabilities. After the acquisition, Mr. Hackney took the position as the president of Franklin American Life Insurance Company. The company, which had been in administrative supervision since August 2, 1991, was taken off administrative supervision on October 18, 1991, after the infusion of capital by Thunor Trust.

One of Mr. Frankel's apparent aliases appeared as the beneficiary of the original Thunor Trust. The original Form A filing requesting the department's approval of Thunor Trust's acquisition of Franklin American Life Insurance Company and its holding company listed Mr. Eric Cornell Jensen as the beneficiary. The amended Form A replaces Mr. Jensen with apparent relatives of the three original grantors. According to interoffice correspondence between insurance division staff, Mr. Hackney told one of the insurance examiners that he and Mr. Jensen had worked together in 1991 in banking. Mr. Hackney told the examiner that Mr. Jensen was with Liberty National Securities, Inc., and that he originally was interested in getting in the insurance business but later decided to stay with the brokerage firm. According to the correspondence, Mr. Hackney stated this as the reason why the name Mr. Eric Jensen was subsequently removed from the Form A filing. The name Eric Jensen does not appear on any documents relating to Liberty National Securities, Inc., but a similar apparent alias of Mr. Frankel, Mr. Eric Stevens, appears on several bank accounts and wire transfers of the brokerage firm.

According to the indictment, the three grantors were merely nominees Mr. Frankel had misrepresented as financial contributors to the trust. Although Mr. Frankel's name did not appear in the Trust Agreement, he actually provided the \$3.75 million to purchase a controlling interest in Franklin American Life Insurance Company and its holding company, according to federal officials.

The federal indictment noted that following the 1991 acquisition of Franklin American Life Insurance Company, the company's cash reserves of approximately \$18 million were deposited with Liberty National Securities, Inc., a brokerage firm registered in Tennessee, with its principal place of business located in Ohio at the time. Mr. Hackney caused the funds to be placed with Liberty National Securities, Inc., most likely at the direction of Mr. Frankel. According to the indictment, Mr. Frankel actually operated as Liberty National Securities, Inc., out of his residence at 889 Lake Avenue, Greenwich, Connecticut. Officials from Franklin American Life Insurance Company indicated that they had dealt with Mr. Frankel at Liberty National Securities, Inc., and that they had first known him as Eric Stevens and later as David Rosse.

Following the acquisition of Franklin American Life Insurance Company, Thunor Trust, or other entities established by Mr. Frankel, acquired other insurance companies. The cash reserves of those companies were also deposited with Liberty National Securities, Inc. Reportedly, Mr. Frankel represented that the assets would be safely invested in United States Government securities. Once the assets were sent to Liberty National Securities, Inc., usually by wire transfer, Mr. Frankel sent or caused to be sent monthly statements to Franklin American Corporation and other entities. According to the indictment, these statements fraudulently represented that the assets were invested and that certain trades had been conducted which resulted in reported profits or losses. Fraudulent confirmation slips indicating trades in United States Government securities were also sent to Franklin American Corporation. Allegedly, Mr. Frankel caused Thunor Trust and insurance companies owned by Thunor Trust to enter into reinsurance agreements. Under reinsurance agreements, one insurance company generally sells some of its existing policies to another insurance company for cash. The selling company gains the immediate benefit of the cash but relinquishes the right to future premiums paid by those policyholders. Through these reinsurance agreements (sales of existing policies to other insurance companies), the cash reserves were increased for the Thunor Trust companies. These additional cash reserves were subsequently placed under the control of Mr. Frankel, operating as Liberty National Securities, Inc. After Mr. Frankel received cash reserves from the various insurance providers for investment, Mr. Frankel allegedly embezzled the majority of the funds by transferring the funds to other bank accounts controlled by him, both within and outside the United States.

The fraudulent trading information allegedly supplied by Mr. Frankel was compiled and reported to the department through quarterly and annual financial statements submitted to the department by the employees at Franklin American Life Insurance Company. The company reported that the first trades allegedly made through Liberty National Securities, Inc., occurred in November 1991. The reported volume of trading of Franklin American Life Insurance Company's United States Government securities continued to escalate through 1995. The profitable strategy of trading United States Government securities on a daily basis allegedly doubled Franklin American Life Insurance Company's bond portfolio, which had reached a reported \$44 million as of March 31, 1996.

In 1994, the Financial Affairs Director of the insurance division was aware of and concerned over the reported volume of trading and apparently met with Mr. Hackney to discuss the matter. Mr. Hackney's explanations apparently appeased those concerns. In 1996, those concerns apparently reemerged after the company reportedly turned over its entire portfolio of government securities 245 times during its 1995 fiscal year. The director requested a "target examination" of the company's trading activities, which was conducted by two analysts from the department. The examination did not reveal any illegal activity but failed to provide the division staff with a plausible reason for the company's trading activities. Furthermore, the work performed by the two analysts was not supported by any documentation. A required report on the procedures performed and findings was not prepared.

The department also received confirmations from Liberty National Securities, Inc., as part of the two examinations conducted of Franklin American Life Insurance Company as of December 31, 1992, and December 31, 1997, respectively. The confirmations from the 1992 examination were allegedly signed by Mr. William Kok, the President of Liberty National Securities, Inc., and attested to the amount of cash or United States Government securities allegedly held by the brokerage firm. The examiners on the first examination accepted the confirmation without questioning its propriety. The confirmation from the 1997 examination was allegedly signed by Ms. Karen Timmins, Vice President and Treasurer of Liberty National Securities, Inc. As discussed below, the examiner on the latter examination, alerted by division staff concerns over the custody of the securities and the unusual volume of trades, did question the propriety of the purported trades.

#### *Scheme Starts to Unravel (August 1998)*

The department contracted with Mr. Billy Lovelady, a former senior insurance examiner from Utah, to perform the examination of Franklin American Life Insurance Company for the five-year period ended December 31, 1997. This review was initiated in August 1998, at which time examiners in Mississippi were also performing an examination of insurance companies affiliated with Franklin American Life Insurance Company and Franklin American Corporation.

The main issue during the examination in Tennessee was the noncompliance issue regarding the alleged holding of the company's securities by Liberty National Securities, Inc., and whether the department should "admit" (recognize according to NAIC guidelines and state statutes) the assets of the company as of December 31, 1997. Since Mr. Lovelady was unable to verify the assets held by Liberty National Securities, Inc., as of December 31, 1997, and since a broker-dealer by law is not a permissible holder of such securities in Tennessee, department regulations stated that the treatment of such assets should not be admitted at the examination date. In insurance examination reports, assets that are not admitted are removed from the balance sheet as though they did not exist. As the securities under consideration were material to the company, if they were not admitted, the report would show the company as being insolvent. These considerations were apparently shared with an examiner from Mississippi. Although

Mississippi does not have a similar regulation requiring securities be held by a banking institution, the concerns by officials from both states regarding Liberty National Securities, Inc., had increased because of this issue.

In December 1998, Mr. Lovelady requested that Franklin American Life Insurance Company officials move the cash allegedly with Liberty National Securities to a banking institution, as required by the *Rules of Department of Insurance*, because the alleged trading had become less frequent and because of the concerns mentioned above. According to a memorandum from Mr. Lovelady to the department, on December 28, 1998, the company agreed with the request and transferred approximately \$69 million to an account with Prudential Savings Bank, F.S.B., located in Atlanta, Georgia. A custody agreement between Franklin American Life Insurance Company and Prudential Savings Bank was also being negotiated. On January 12, 1999, approximately \$69 million was transferred out of this account, according to the company's statements from Prudential Savings Bank. These transfers were apparently made without the knowledge and approval of the department.

On January 27, 1999, Mr. Lovelady visited the securities division within the Department of Commerce and Insurance and discovered some disturbing facts about Liberty National Securities, Inc. Foremost, the company did not appear to have sufficient financial standing to serve as a depository for the Franklin American Life Insurance Company assets, in that its financial statements indicated a net worth of less than \$60,000 when it was allegedly holding Franklin American Life Insurance Company's assets of approximately \$69 million. In addition, the brokerage firm's financial statements made no mention that it held customer securities. Also, the brokerage firm's registration with the securities division did not indicate that the brokerage firm was trading in government securities. Furthermore, the division's records did not reflect the New York address as shown on the broker's trading confirmations submitted by someone at Liberty National Securities, Inc., to Mr. Hackney or Mr. Gary L. Atnip, Chief Financial Officer for Franklin American Life Insurance Company. Mr. Lovelady's February 1, 1999, memorandum to the Chief Examiner, Mr. Don Spann, stated, "There is a possibility that the Company has been looted of its assets."

During this time, in Tennessee, Franklin American Life Insurance Company had retained the services of various individuals to meet with department officials in efforts to promote the company's position that it should be able to continue to trade during the period that the company was developing a custodial agreement and the department was considering whether the statute requiring the custodial agreement was outdated. One of those retained was Mr. Harlan Mathews, an attorney with the law firm of Farris, Mathews, Branam, and Hellen. Mr. Mathews was formerly a U.S. senator from the State of Tennessee, the Commissioner of the Tennessee Department of Finance and Administration, Deputy to the Governor, and the State Treasurer. According to a Mississippi official, other individuals were also visiting their state on behalf of the related corporate entities owned by Thunor Trust in Mississippi.

According to the department's legal services section, two other individuals representing Franklin American Life Insurance Company also met with department officials in January 1999: Mr. Tom Quinn, an attorney with America Annuity and Life Acquisition; and Mr. Larry Martin; an attorney from New York. State auditors' efforts to contact Mr. Quinn were exhausted. Mr. Martin's attorney, Mr. Austin V. Campriello, was contacted and stated that Mr. Martin declined an interview.

A Mississippi official stated that an examination in that state had also raised questions about Liberty National Securities, Inc., and that its examiner was reviewing the ownership and relationship of the brokerage firm to the related corporate entities owned by Thunor Trust, located in Mississippi. The Mississippi official stated that the answers given by Franklin American Life Insurance Company representatives regarding Liberty National Securities, Inc., were not consistent and were not plausible.

On February 8, 1999, a letter from the Tennessee Department of Commerce and Insurance to Franklin American Life Insurance Company informed the company that the department was allowing it to continue to trade its investment portfolio consisting of government securities and to hold the same in "street-name" for a period not to exceed 60 days. A security in "street-name" is an endorsed certificate that can be freely traded (on Wall Street) without any additional endorsements. The effect of holding securities in "street name" was to allow for the securities to be transferred efficiently. However, in trading in this manner, Franklin American Life Insurance Company's ownership in the securities was not secured through a banking institution. The letter was silent with regard to the removal of the company's money from Prudential Savings Bank. Franklin American Life Insurance Company representatives could have continued to make trades with the money in Prudential Savings Bank. Therefore, the letter did not envision preventing the company from trading. However, for Franklin American Life Insurance Company to trade through Liberty National Securities, Inc., and make the kinds of profits company officials were alleging they could make through Liberty National Securities, Inc., Franklin American Life Insurance Company officials would have had to move the money to Liberty National Securities, Inc.

On March 12, 1999, the Mississippi Insurance Department requested answers from the related corporate entities domiciled in Mississippi regarding Thunor Trust and Liberty National Securities, Inc. The company's response was received by the Mississippi Insurance Department on April 8, 1999. The company reported that among other things, the sole owner and sole beneficiary of Thunor Trust was the Saint Francis of Assisi Foundation. The company's response stated that the "Foundation" was associated with the Monitor Ecclesiasticus Foundation and the Vatican. The purpose of the foundation was to serve and help the poor and to alleviate suffering, according to the response. The information described the members of the Board of Trustees of the Saint Francis of Assisi Foundation as Reverend Father Peter Jacobs, Edward D. Collins, Thomas A. Bolan, John A. Hackney, and Mr. Atnip. The response stated that as of March 31, 1999, the foundation had unencumbered assets of over \$1.9 billion. The information also indicated that as of April 5, 1999, the Saint Mary's Foundation for the

Protection of Homeless Children had purchased 100 percent of the stock of Liberty National Securities, Inc.

During the month of April 1999, Mississippi regulators and officials from the Attorney General's Office in Mississippi received conflicting information from various Catholic dioceses the assistant attorney general called regarding the affiliation between the Vatican and Thunor Trust. The Commissioner of the Mississippi Insurance Department requested a meeting of department officials; representatives from the Tennessee Department of Commerce and Insurance; Father Peter Jacobs of the Saint Francis of Assisi Foundation; Mr. Hackney; Mr. Atnip; and Mr. David Rosse, financial advisor for the Foundation. According to the subsequent indictment, Mr. Frankel controlled the St. Francis of Assisi Foundation using the alias David Rosse. The Commissioner also requested that the money of the Mississippi related corporate entities, allegedly invested with Liberty National Securities, Inc., be placed in a bank.

On April 8, 1999, wire transfers of approximately \$57 million were placed in Franklin American Life Insurance Company's account with The Prudential Savings Bank in Atlanta, Georgia, in accordance with the February 8, 1999, letter from the Tennessee Department of Commerce and Insurance, which allowed the company to trade its investments for 60 days outside the requirements of the law. It appears the majority of these funds originated from Swiss bank accounts and were first wired to the company's First Tennessee Bank account. From there, the money was wired to The Prudential Savings Bank.

On April 22, 1999, Mr. Lewis R. Donelson, III, a partner at the Memphis, Tennessee law firm Baker, Donelson, Bearman, and Caldwell and formerly a Tennessee Commissioner for Finance and Administration and a member of the Tennessee Higher Education Commission, met with Commissioner Sizemore to discuss the department's treatment of Franklin American Life Insurance Company, in light of its lack of a proper custodial agreement. Mr. Donelson stated that he represented the Saint Francis of Assisi Foundation, which had purportedly purchased the Thunor Trust that controlled Franklin American Life Insurance Company. Mr. Donelson stated that a person contacted him by the name of David Rosse. According to Mr. Donelson, Mr. Rosse informed him that the Tennessee insurance examination report on Franklin American Life Insurance Company was going to be qualified because of its lack of a proper custodial agreement. Mr. Donelson agreed to discuss the matter with Commissioner Sizemore. Mr. Donelson stated that the insurance company had agreed to physically maintain all its securities in the company's possession or in a proper custodial arrangement, which would bring them in compliance with Tennessee rules. Mr. Donelson also stated he suggested that the Commissioner should consider extending the examination date to allow the company to be shown as solvent and compliant. According to Mr. Donelson, Commissioner Sizemore agreed to consider extending the examination date so that the securities would be certified to be in a proper custodial arrangement at the time the examination was concluded.

In regard to any further communications with representatives from the insurance company or the foundation, Mr. Donelson stated that he had spoken with Mr. Harlan Mathews on one occasion and received a phone call from an individual from Virginia. Mr. Donelson could not specifically recall the man's name but stated the man said he was in the healthcare business and was assisting the foundation with its investments. Mr. Donelson stated that the individual called him for his assistance in purchasing a hospital in Knoxville, Tennessee, on behalf of the foundation.

On April 29, 1999, a meeting was held in Mississippi with officials from Tennessee and Mississippi; Mr. Hackney and Mr. Atnip, who were representing Franklin American Corporation/Thunor Trust; and Father Peter Jacobs, representing the Saint Francis of Assisi Foundation. Of those representatives requested to attend, Mr. Rosse did not attend. According to the Mississippi officials, the representatives that did attend were not responsive to the questions regarding Liberty National Securities, Inc. In addition, the related corporate entities in Mississippi had not deposited the money allegedly invested with the brokerage firm into a banking institution as requested by the Mississippi Commissioner. Therefore, the Mississippi Commissioner placed the related corporate entities under administrative supervision.

On May 5, 1999, the Greenwich fire and police departments were dispatched to a fire alarm reported at 889 Lake Avenue, residence of Mr. Frankel.

On May 7, 1999, Mr. Hackney informed Mississippi officials that the funds of the related corporate entities in Mississippi allegedly invested with Liberty National Securities, Inc., were missing. On the same day, Mr. Gary Atnip, Chief Financial Officer of Franklin American Life Insurance Company, informed the Tennessee Department of Commerce and Insurance that the Federal Bureau of Investigation had taken control of Liberty National Securities, Inc., and that repeated efforts to contact representatives of the brokerage firm had been unsuccessful.

On May 10, 1999, Mr. Hackney authorized the transfer of the \$57,419,139.31 from The Prudential Savings Bank to the State of Tennessee's account with First American National Bank in Tennessee.

On May 10, 1999, the State of Mississippi and Franklin American's affiliated insurers domiciled in Mississippi entered into a voluntary rehabilitation agreement appointing that state's insurance Commissioner as receiver.

On May 11, 1999, the State of Tennessee and Franklin American Life Insurance Company entered into a voluntary rehabilitation agreement appointing the Commissioner as receiver. The title, custody, and control of all the company funds were placed with the Commissioner, according to the consent order by the Davidson County Chancery Court on May 11, 1999.

On July 2, 1999, Commissioner Douglas Sizemore, in his capacity as Receiver of Franklin American Life Insurance Company, and Mr. J. Knox Walkup, Special Deputy

Receiver, requested that the Chancery Court, 20<sup>th</sup> Judicial District (Davidson County), approve a settlement agreement motion that the State of Tennessee's receivership and the similar receivership proceedings pending in the states of Mississippi, Missouri, Arkansas, and Oklahoma share in the \$57.5 million secured by the State of Tennessee from Franklin American Life Insurance Company's account at Prudential Savings Bank. The Tennessee receivership agreed to tender \$17.5 million to the out-of-state receivers. The order approving this compromise and settlement was filed on July 9, 1999.

On September 4, 1999, Mr. Frankel was taken into custody in Hamburg, Germany.

In February 2000, the National Association of Insurance Commissioners (NAIC) sent a team to review the regulatory function of the Tennessee Department of Commerce and Insurance's insurance division. On March 21, 2000, NAIC sent the department notice that the association's Financial Regulation Standards and Accreditation Committee had suspended Tennessee's accreditation.

In April 2000, NAIC's Ad Hoc Task Force on Solvency and Anti-Fraud released its report and recommendations. The recommendations on issues the members deemed of highest priority included "requiring states to obtain expert assistance on examinations of insurers having high risk or complex investment strategies," "requiring proactive communication by the domestic state to other states that have a regulatory interest in a troubled insurer," the development of additional examination procedures to consider "risk factors and significant changes in investment portfolios and trading volume," adoption of "an interrogatory (to accompany the financial statements) affirming that the insurer's investments are in custody at a qualified bank," the creation of a Form A Database that could be accessed to determine affiliations and ownership, and to require "a notice of termination by the custodian to the insurance department in the event an insurer withdraws a significant percentage of the assets in custody."

The Division of State Audit's review was centered on the information available to the department from the 1991 acquisition of Franklin American Life Insurance Company by Thunor Trust until May 1999 and what if any actions were taken by Tennessee regulators with the Department of Commerce and Insurance. An emphasis was placed on key events during this time period.

The Department of Commerce and Insurance is headed by a Commissioner who is appointed by the Governor and reports directly to the Governor. Ms. Elaine McReynolds was sworn in as Commissioner in January 1987 and left state service in April 1994. Mr. Allan Curtis served as the Commissioner through December 1994. Mr. Sizemore was sworn in as Commissioner in January 1995 and left state service in October 1999. Ms. Anne Pope is currently serving as Commissioner. The Commissioner is assisted by two deputy Commissioners, a legal services section, an internal audit section, and seven divisions. Each division is headed by an assistant commissioner except for Consumer Affairs, which is headed by a director. This review involved documents from and interviews with staff from the Commissioner's office, legal services section, the Division

of Insurance, and the Division of Securities. The Division of Insurance is responsible for enforcing all insurance laws of the state and for supervising all life, casualty, and other insurance companies authorized to transact business in Tennessee. The Division of Securities is responsible for enforcing all state laws pertaining to securities dealers and salespersons.

The Financial Affairs Director, Division of Insurance, Mr. Bill Hosea, reports to the Assistant Commissioner of the division. During the review period, the Assistant Commissioner position was occupied by Mr. David Kumatz, for the period 1988 to the middle of calendar year 1993; by Ms. Sharon Roberson, from the middle of calendar year 1993 until the middle of calendar year 1997; and by Mr. Neil Nevins, from late 1997 to the time of this report.

The Chief Examiner, Mr. Don Spann, is responsible for supervising approximately 15 insurance examiners and two financial analysts. Mr. Spann held this position for the period under review. Mr. Spann reports directly to Mr. Hosea. Mr. Hosea has held this position for all periods under review. According to Mr. Spann, the division currently receives approximately 1,600 annual and quarterly financial statements from insurance companies doing business in Tennessee every year. Mr. Spann stated that the division's financial analysts review these financial statements and compare them to the company's independently audited financial statements also filed with the division.

Those insurance companies domiciled in Tennessee are required by statute to have a full examination every five years. The full examinations by department staff are more in-depth; the company's entire operations are reviewed rather than just its financial status. According to Mr. Spann, the division completes between 15 and 30 examinations each year.

## **EXECUTIVE SUMMARY**

The review determined that because department staff failed to exercise sufficient professional skepticism, conducted inadequate procedures and review, and misapplied procedures, regulators failed to detect the fraudulent nature of Mr. Frankel's activities before May 1999. The department's gross breakdown in its regulation of Franklin American Life Insurance Company occurred despite significant warning signs of questionable activities. Furthermore, there was a lack of communication between insurance division staff and other department officials.

In 1986, when the company known as Franklin American Life Insurance Company was established, it did not appear to be significantly different in organization or operations from most other insurance companies regulated by the department. In August 1991, the company was placed under administrative supervision due to insufficient capital and surplus. In the later part of 1991, Franklin American Life Insurance Company was acquired by Thunor Trust. The acquisition of Franklin American Life Insurance Company by the trust appeared to rescue the insurance company, even though department

staff realized that it was unusual for a trust to acquire an insurance company. Furthermore, the trust was unusually structured in that it was an irrevocable trust agreement that placed the control of the acquisition funds and the operation of Franklin American Life Insurance Company exclusively with a sole trustee. From this point on, Franklin American Life Insurance Company began to present unusual circumstances for the department to consider.

Faced with the apparent good faith efforts of the representatives of the trust to salvage the struggling insurance company, department regulators approved the acquisition. At that time, the department followed its general philosophy that it was in the best interests of the state to allow new management to run the operations of financially troubled insurance companies rather than for the department to take over the operations in a rehabilitation or to liquidate such companies. In addition, the department took the approach that even though the acquisition was unusual, unless there were laws, regulations, or policies which would clearly prohibit such an acquisition, it did not have the authority to deny the request for the acquisition.

In light of Franklin American Life Insurance Company's poor financial condition at the time of the acquisition, the department, pursuant to its rules, required the company to submit its financial statements on a monthly basis, rather than quarterly, for the purposes of monitoring its financial transactions.

Notwithstanding this initial extra oversight, throughout its remaining dealings with Franklin American Life Insurance Company, department staff and officials continued to regulate the company using the routine basic approaches noted above. Over the seven and a half years that the department regulated Franklin American Life Insurance Company before the company ceased operations in May 1999, department staff and officials had several opportunities to take more aggressive action against the company. However, many of these situations involved unusual transactions or business operations that were confusing and not easily understood. If staff had exercised reasonable skepticism in trying to understand these matters, the fraudulent nature of the activities would have become apparent.

But instead of demanding explanations or trying to understand the company's representations, department staff and officials reacted to these issues by deciding that even though the circumstances appeared unusual, unless there was a law, regulation, or policy that was clearly violated, they could take no action. Furthermore, even when faced with a clear violation of a department rule, as was the case due to the company's failure to maintain assets with an independent custodian, the department waited nearly two years to take action (from 1997 to the later part of 1998). This delay continued, despite recommendations from division analysts that an expert should review the company's unusual and seemingly excessive trading of government securities. The department's inaction in regard to this violation was due to the apparent lack of staff and funding; the nonavailability of the contract examiner who eventually conducted the last examination of the company; the apparent desire to assist the company in its efforts to

survive; and a very narrow reading of the rules, all of which served to diminish the extent and effectiveness of regulatory activities.

Despite the department's failures, it should be noted that because the department eventually required Franklin American Life Insurance Company officials to place the company's cash reserves in a custodian bank, as required by department rules, Tennessee was able to recover approximately \$57 million of the company's funds allegedly entrusted with Liberty National Securities, Inc., when other states with related corporate entities did not. Under the compromise and settlement with the four other states involved, the State of Tennessee Commissioner tendered \$17.5 million to the out-of-state receivers. Therefore, the net recovery, to this point, is approximately \$40 million of the company's funds, out of the approximately \$69 million in alleged total assets.

The review did not find that any of the inadequacies noted above were intentional on the part of the department staff. In addition, this review did not substantiate the allegations that Franklin American Life Insurance Company was given any special treatment by the department.

In regard to the allegation that the department allotted Franklin American Life Insurance Company special treatment when it placed the troubled company in administrative supervision rather than into receivership in 1991, this allegation was unsubstantiated. Although Mr. Richard Franklin Keathley, formerly the president and a founder of the insurance company, served as the Commissioner of the department in 1974, he had effectively resigned eight months before the department placed Franklin American Life Insurance Company in administrative supervision in August 1991. This review did not find that the department's actions favored the company or Mr. Keathley.

In regard to the allegation that an analyst gave special treatment to Franklin American Life Insurance Company during his analysis of the company's financial statements, this allegation was also unsubstantiated. In February 1996, Mr. Billy Williams, then an analytical reviewer with the division, incorrectly performed the analysis of the company's financial statements in regard to the control of the company's securities. The financial statements under review indicated that the company did not have exclusive control of its securities. In his analysis, Mr. Williams incorrectly indicated that the company did have exclusive control of its securities. Although this error resulted in the item not being shown as an exception in Mr. Williams' analysis, he did write a comment on his analysis checklist, that the company had reported that its broker held its securities. Neither the error nor the comment were noticed in the subsequent supervisory review of the analysis checklist. This review determined that the error was unintentional and did not find any impropriety in Mr. Williams' acceptance of the assistant treasurer position with the company.

The review did find that even when staff correctly followed procedures, and information was appropriately shared between the Insurance Division and the Securities Division, information was not used by department officials in their decision making regarding the regulation of Franklin American Life Insurance Company. As pointed out

by a contract examiner, the company was not in compliance with the department rules requiring a custodial agreement with a bank for the holding of the company's securities. In late December 1998, based on a request by the department, the company allegedly liquidated its holdings with Liberty National Securities, Inc., and deposited cash into a bank. Without the knowledge or approval of the department, company representatives withdrew the cash and transferred it back to Liberty National Securities, Inc., in the middle of January 1999. Soon afterwards, individuals representing Franklin American Life Insurance Company began meeting with department officials in efforts to allow the company to use the services of Liberty National Securities, Inc., as before.

In the later part of January 1999, the contract examiner visited the department's securities division and gathered information on Liberty National Securities, Inc. The information the contract examiner obtained regarding the brokerage firm was inconsistent with the statements and assertions of the officials with Franklin American Life Insurance Company. This discovery presented critical questions about the relationship between the company and the brokerage firm. Specifically, the contract examiner found that Liberty National Securities, Inc., had less than \$60,000 net worth, and the firm's registration made no mention of a New York City address or that the firm was trading in government securities. The contract examiner concluded that it was possible that the brokerage firm was just a front and that Franklin American Life Insurance Company had been looted of its assets invested with Liberty National Securities, Inc. Some of this critical information was shared with the insurance division staff, but apparently the then Commissioner and department legal staff were not apprised of these disturbing facts.

Following a February 2, 1999, meeting between Franklin American Life Insurance Company representatives and department officials, the then Commissioner decided to allow the company to resume the trading of its assets with Liberty National Securities, Inc., for an additional 60 days. Although this decision was contrary to department rules, which required a custodial agreement with a bank for the holding of insurance company securities, in the Commissioner's opinion, it gave Franklin American Life Insurance Company a reasonable period in which to comply with the rule. However, this decision was made without the full facts and information available at the time.

The decision-makers were apparently not aware of the serious concerns held by the insurance division chief examiner and the contract examiner regarding the brokerage firm, Liberty National Securities. In addition, the insurance division staff stated they were silent about these concerns because the insurance procedures did not address inconsistent information regarding a brokerage firm and its registration and, in part, because it was their opinion that fraud involving the funds thought to be invested with Liberty National Securities, Inc., was no longer an issue since company officials had been able to present the funds in question and had deposited them in a banking institution.

Unbeknownst to the department, during early 1999, the company's funds allegedly invested with Liberty National Securities, Inc., were actually in a Swiss bank account controlled by Mr. Frankel. Presently available information indicates that the reported trades of government securities on behalf of Franklin American Life Insurance

Company did not actually occur. The brokerage firm's statements and other documents related to the trades were apparently bogus. These alleged activities of Mr. Frankel resulted in false financial information in Franklin American Life Insurance Company's financial statements that were prepared based on the brokerage firm's alleged trades. The inclusion of the false trading information and reported gains from these trades in the financial statements of Franklin American Life Insurance Company gave the insurance company the appearance that it was financially sound when, in fact, it was not.

However, in keeping with the then Commissioner's demand to have either a custodial agreement with a bank in place or for the company to return the funds to a bank after the 60-day period, Mr. Frankel moved \$57 million from his Swiss bank account to Prudential Savings Bank on April 8, 1999. When Mississippi officials requested that the funds of related corporate entities in Mississippi be placed in a banking institution in late April 1999, Mr. Frankel was unable or unwilling to produce those additional funds, also purported to be invested with Liberty National Securities, Inc. Prior to the reported fire at Mr. Frankel's residence in Greenwich, Connecticut on May 5, 1999, Mr. Frankel had fled the country. On September 4, 1999, Mr. Frankel was taken into custody in Hamburg, Germany, and is fighting extradition to the United States.

The department's misapplication of procedures, insufficient professional skepticism, inadequate procedures, and lack of communication all contributed to the failure to detect Mr. Frankel's fraudulent activities. Those failures in the regulatory process of Franklin American Life Insurance Company are summarized below.

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## DETAILS OF THE REVIEW

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### **(1991) THE DEPARTMENT APPROVED THE ACQUISITION BY THUNOR TRUST WITHOUT QUESTIONING ITS ODDITIES AND WITHOUT FULLY UNDERSTANDING THE TRANSACTION**

In a June 1999 newspaper article, several allegations were made calling into question the propriety of the department's approval of the 1991 acquisition of Franklin American Life Insurance Company by Thunor Trust.

#### Department Was In Compliance With State Statutes

The documentation provided to the Division of State Audit relating to the 1988 acquisition of Franklin American Life Insurance Company by Franklin American Corporation and the 1991 acquisition of the company and the corporation by Thunor was assessed for compliance with the requirements set out in *Tennessee Code Annotated*, Section 56-11-203, for such acquisitions. This review determined that the department was in compliance with state statutes regarding the filing of all required documents.

#### Comparison of the Acquisition of Franklin American Life Insurance Company and Its Holding Company to Other Acquisitions

The Division of State Audit also obtained a sample of “Form A” filings (documents required by law for acquisitions) for other acquisitions in and around 1990 and compared them with the Form A filing submitted for the Thunor Trust acquisition of Franklin American Corporation and Franklin American Life Insurance Company. This comparison revealed that in the 1993 acquisition of another insurance company, the department requested personal financial statements of the sole general partner of the limited partnership, which had, in essence, formed a new corporation for the purposes of acquiring the insurance company. Under both cases, the entity acquiring the insurance company was treated as a corporation. However, this additional information was not requested of the three individuals (grantors) who allegedly contributed funds to form Thunor Trust. This one difference in the treatment of the two acquisitions by the department is not, in itself, conclusive of preferential treatment. However, considering the rarity of the purchase of an insurance company by a trust, the department’s treatment of Franklin American Life Insurance Company and its holding company raises questions as to whether the department staff failed to exercise due diligence by not requesting more information.

#### Requirements of Acquisitions

*Tennessee Code Annotated*, Section 56-11-203, entitled “Mergers and Acquisitions of Control,” governs the acquisition of any domestic insurer by an individual, organization, or trust. Section 203 states that no person (trust is included in the definition of “person”) may seek to acquire or acquire controlling interest in a domestic insurer unless that person has filed a statement with the insurance department’s Commissioner disclosing certain information regarding the transaction.

Section 203(b)(1)-(13) lists the required contents of the statement that must be filed with the Commissioner before any acquisition of a domestic insurer. Section 203(b)(3) requires fully audited financial information as to the earnings and financial condition of each acquiring party. In the acquisition by Thunor Trust, the department appears to have properly treated the trust as though it was a distinct entity (not an individual) rather than treating the separate individuals as the acquiring party. Thus, the only required financial statements were of the trust itself. This requirement was met by the inclusion of the trust’s financial statements in the Form A filing. However, Section 203(b)(13) authorizes the Commissioner to prescribe, as necessary, additional information.

#### Further Understanding of Transaction Could Have Been Obtained

Had department staff questioned the details of this transaction, they might have determined that Mr. Frankel was the true source of the \$3.75 million used in the acquisition. They might also have contacted the three grantors for personal financial information. In doing so, the department staff may have determined that at least two of the grantors had no knowledge of the trust. At this point in time, it is unknown whether any of the three grantors had knowledge that they were named as grantors contributing to

the acquisition. It is also unknown whether the signatures on the corresponding grantor affidavits attached to Form A were falsified or misrepresented to the grantors. According to federal officials, had the department queried the Central Registration Depository (CRD) for security brokers and dealers on the grantors of Thunor Trust, they would have discovered that Ms. Sonia Dix Howe, one of the grantors, was a registered dealer and had had one customer complaint filed against her. This information could have prompted the department to question Ms. Howe regarding the trust.

### Lack of Documentation

Furthermore, the department files did not contain any documentation of meetings and phone calls one would expect between the department and officials representing Thunor Trust. Compounding the lack of supporting documentation, the former department staff involved in the acquisition did not recall specific details. Therefore, many questions still remain in regard to the department's concerns about a trust purchasing an insurance company.

### Oddities in the Trust

Enough information regarding the acquisition of the company exists to determine that the transaction was unusual. The fact that a trust would acquire an insurance company should have appeared unusual in itself, according to prior history of the department. The fact that the trust was irrevocable and placed the absolute control of the trust with a sole trustee also should have appeared highly unusual. Under this arrangement, Mr. Hackney would control Franklin American Life Insurance Company and its holding company and appoint all the directors. Mr. Hackney would also make all the investment decisions. In reviewing Mr. Hackney's biographical information, it is clear that he had limited experience in the insurance industry. It did appear that several of the individuals named as the new management did have extensive experience in the industry. However, no documentation was maintained by the department regarding any reservations by staff on this matter. Furthermore, it appears unusual that the sole beneficiary of the trust was a third party, and then the third party was subsequently removed. Not only was the third party removed from the trust entirely, but the grantors' affidavits submitted in regard to the amount of money they contributed to the trust specifically state that none of their contributions were obtained from this third-party. The third party in this case was apparently Mr. Frankel, using the name Eric Cornell Jensen.

From the department's viewpoint, it was preferable that another entity purchase the financially troubled Franklin American Life Insurance Company rather than to put the company in receivership. Oftentimes, financial trouble is the direct result of poor management. Therefore, when new management was proposed in the case of the Thunor Trust acquisition, the department was hopeful that the financially troubled company could be turned around and would not have to be put in receivership. Although this proposition was preferable to the department, it did not preclude staff from questioning the arrangement. The statutes authorize the Commissioner to prescribe, as necessary, additional information in regard to acquisitions. In the case of the acquisition of Franklin

American Life Insurance Company, additional inquiries by department staff may not have revealed the true nature of the transaction, if collusion was involved. It is now known that Liberty National Securities, Inc., was a front for the interests that created Thunor Trust. The trust agreement provided sole control over the trust funds to the trustee. Therefore, all the funds provided by the acquisition would be returned to Mr. Frankel's control at Liberty National Securities, Inc. Mr. Frankel's scheme not only provided for the control of the acquisition funds but included the other reserve assets of the insurance company as well. However, it appears that the transaction was unusual and that in reviewing the proposed acquisition, more detail should have been obtained and concerns should have been documented.

#### Notice of Acquisition

On August 29, 1991, Ms. Elaine McReynolds, then Commissioner, received a letter from Mr. Richard Copeland, Interim President of Franklin American Corporation, also signed by Mr. John A. Hackney, "trustee, Thunor Trust," requesting an extension of the Agreed Order of Administrative Supervision under which Franklin American Life Insurance Company was operating. The letter explained that this request was based on plans by Franklin American Corporation, the sole shareholder of Franklin American Life Insurance Company stock, to correct Franklin American Life Insurance Company's capital and surplus impairment problem by selling 2,683,929 newly issued restricted shares of Franklin American Corporation common stock to Thunor Trust for \$3,750,000 in cash. According to the letter, this acquisition would give Thunor Trust ownership of 51 percent of Franklin American Corporation's stock. The requested extension allowed for the additional time needed to conclude the acquisition and also allowed for the company's status with the department to remain the same.

#### Form A Filing

On September 12, 1991, Thunor Trust and Franklin American Corporation filed a "Form A – Statutory Statement and Request for Approval of Acquisition of Control of a Domestic Insurer" with the department. The Form A filing sought department approval for "the acquisition of control of Franklin American Life Insurance Company," a domestic insurer, "by a purchase of a majority of the shares of Franklin American Corporation, the sole shareholder of [Franklin American Life Insurance Company]." The Form A filing also included various exhibits. Exhibit C contained biographical information on John Thomas Bible, proposed director of the company; William Farris, an attorney with the law firm of Farris, Mathews, Branam, and Hellen; Eric Cornell Jensen, sole beneficiary of the trust; John Alvis Hackney, Trustee of Thunor Trust, and proposed Chairman of the Board of Directors and Chief Executive Officer of the company; Gary Lane Atnip, Chief Financial Officer for Franklin American Life Insurance Company; John Martin Jordan, proposed director; Taylor Bagley Moore, proposed Executive Vice President of the company; William Thomas Patterson, proposed director; Mark Christopher Shuki, Attorney-in-fact for the grantors of Thunor Trust; and Billy James Canfield, proposed Vice President of the company.

On September 12, 1991, Mr. David Kumatz, then the Assistant Commissioner over the insurance division with the Department of Commerce and Insurance, sent a letter to Mr. Richard Copeland acknowledging receipt of the Form A filing. Mr. Kumatz stated in the letter that the filing did not appear complete and would have to be completed in accordance with Tennessee law before it could be considered by the department. This letter did not provide any specifics regarding the information missing from the Form A filing. Mr. Kumatz, an attorney, further stated that, due to the Form A filing, the department would extend the Agreed Order of Supervision of August 2, 1991, so that the company's current situation would remain unchanged while the department considered the proposed acquisition.

#### Amendment One to Form A

On September 18, 1991, the department received "Amendment No. 1" to the Form A filed on September 12, 1991. This amendment provided additional information, including (1) the identity of and biographical information on the grantors of the trust, Mr. Mark Christopher Shuki, Ms. Sonia Dix Howe, and Mr. Edward M. Krauss; (2) a copy of the trust agreement revised to include the identity of the grantors; (3) audited financial information for the Thunor Trust; and (4) a certification by the trustee of the trust, Mr. John Hackney, concerning the shares of restricted capital stock of Franklin American Corporation to be transferred to the Thunor Trust.

#### Amendment Two to Form A

Also, on September 18, 1991, the department received "Amendment No. 2" to the Form A originally filed on September 12, 1991. This amendment provided additional information, including (1) affidavits of the original grantors of the Thunor Trust, certifying their individual contribution amounts, source of contributed funds, and control relationships; (2) a statement terminating the prior trust and any interest Mr. Eric Jensen had in the prior trust; and (3) a new trust agreement with new beneficiaries (direct relatives of the grantors). The original Form A filed on September 12, 1991, included Mr. Eric Cornell Jensen as the sole beneficiary. This amendment replaced Mr. Jensen with apparent relatives of the three original grantors, as the new beneficiaries had last names that corresponded with the last names of the grantors.

#### Amendment Three to Form A

On September 30, 1991, the department received "Amendment No. 3" to the Form A originally filed on September 12, 1991. This amendment provided additional information, including (1) a more extensive business plan for Franklin American Life Insurance Company that addressed departmental concerns about the past business practices; (2) biographical information on certain proposed employees of the company, Mr. John Hackney, Mr. Taylor Moore, Mr. Gary Atnip, Mr. Billy Canfield, and Ms. Judy Lowrey; and (3) an affidavit of the trustee, Mr. Hackney, affirming that relatives or employees of the trust's grantors would not be allowed to receive commission income from the sale of products offered by the corporation or the life insurance company. The

revised business plan addressed losses from advance commissions given to life insurance agents, the purchase of a computer system at a cost of \$1,200,000, the purchase of land for the corporate headquarters that was never built, the registration with the Securities and Exchange Commission, and the unprofitability of the company's entry into the accident and health insurance business.

### Approval of Acquisition

According to an October 7, 1991, letter from then Commissioner Elaine McReynolds to Mr. John Jordan, the attorney for Franklin American Life Insurance Company, the department had completed its review of the Form A and Amendments 1, 2, and 3 filed by Thunor Trust, regarding its acquisition of Franklin American Life Insurance Company and its holding company. In this letter, Commissioner McReynolds stated, "Based on this review, it appears that the filing meets the requirements of the Insurance Holding Company System Act of 1986, specifically of T.C.A. §56-11-203, and is hereby approved."

It appears that the department's approval of the Form A filing was based in part on a review of the acquisition by Mr. Kumatz, Mr. Hosea, Mr. Spann, and Ms. Sharon Roberson, then the Chief Counsel for the Insurance Division. According to the current and former staff of the department, this was the first and only time they recall a trust purchasing an insurance company. In an October 8, 1991, memorandum from Mr. Kumatz to Commissioner McReynolds, Mr. Kumatz stated that the proposed acquisition was "thoroughly reviewed" by the staff mentioned above for compliance with *Tennessee Code Annotated*, Section 56-11-203, and he recommended that it be approved by the department.

However, no information concerning this review was found in files obtained from the department. When questioned about this review, Mr. Spann told us that he had no specific memory of conducting a review of the 1991 acquisition. He said that it would be normal procedure for examination section staff to review the required filing information from the parties to a proposed acquisition and forward the information to the department's legal counsel for approval. Mr. Hosea recalls reviewing the Form A filing for completeness. He stated that no one in the insurance division would have conducted any form of background check on the grantors. Mr. Hosea stated that he did recall having a problem with a trust purchasing an insurance company. He said that the attorneys for the department at the time decided that a trust was within the legal definition of "a person" and therefore did not preclude the trust from acquiring Franklin American Life Insurance Company. Ms. Roberson did not recall that there were any concerns about the grantors or the trust arrangement. Ms. McReynolds declined to be interviewed but stated that she did not recall specifics about the acquisition.

Based on this review, it was determined that the department was in compliance with state statutes regarding the filing of all required documents for the acquisition of Franklin American Life Insurance Company and its holding company by Thunor Trust.

**(1993) EXAMINERS FAILED TO NOTE IMPROPER HOLDING OF SECURITIES BY LIBERTY NATIONAL SECURITIES, INC.**

**Examiners Neglected to Note Improper “Holding”**

During the insurance division’s examination of Franklin American Life Insurance Company in 1993, the examiners failed to note the improper holding of the company’s securities by the brokerage firm, Liberty National Securities, Inc. Although the holding of such securities is required to be with a bank or clearing corporation through a custodian bank, the examiners accepted the verification from the brokerage firm regarding approximately \$23 million in United States Treasury Notes allegedly held by Liberty National Securities, Inc.

**Mr. Frankel’s Activities Were Undetected by Examiners**

Although the investigation into Mr. Frankel’s alleged fraudulent activities is still ongoing, it appears at this point that Mr. Frankel was controlling Liberty National Securities, Inc. It also appears that once cash from Franklin American Life Insurance Company and other insurers was placed with the brokerage firm, Mr. Frankel then embezzled the cash and transferred it to various bank accounts under his control. Apparently, the alleged trading of United States Treasury Notes and the corresponding verifications of investments held were pure fabrications. The lack of due diligence on the part of the examiners in accepting the confirmation and disregarding the applicable requirements resulted in extending the period that Mr. Frankel’s scheme went undetected.

**Requirement for “Holding” of Insurance Company Securities**

In June 1993, insurance division staff began their examination of the Franklin American Life Insurance Company for the three-year period ended December 31, 1992. During the time of this examination, the *Rules of Department of Insurance, Division of Insurance*, Chapter 0780-1-46, required that insurance company securities, including bonds, notes, debentures, stock certificates, and other like securities be 1) held by the insurance company in definitive certificate form; 2) held by a member bank of the Federal Reserve System; 3) held by a clearing corporation through a custodian bank; or 4) placed on deposit with the Commissioner of Insurance to be maintained under a separate custodial agreement between a commercial bank or clearing corporation, the insurance company, and the department. The purpose of this rule was to assist in the verification of insurance company assets during examinations conducted by the department and to safeguard the securities from loss or theft.

### “Holdings” Verified Through Custodian Affidavits

A routine procedure in examinations conducted by the division is to verify the existence of assets of the insurer. For verification purposes of those securities held under custodial agreements, the rule required insurance companies to execute the appropriate “custodian affidavits forms” A, B, or C. Form A was for use by a custodian bank for securities entrusted to its care. Form B was for use in instances where a custodian bank maintained securities on deposit with a clearing corporation. Form C was for use where ownership was evident by book entry at a Federal Reserve Bank. The rule further stated that the failure to provide the appropriate custodian affidavit would result in the insurance department’s treating the insurance company’s securities as nonadmitted assets (nonexisting).

### Destruction of Examination Work Papers

The division’s examination of Franklin American Life Insurance Company included the company’s financial transactions for the period January 1, 1990, through December 31, 1992. The subsequent examination of Franklin American Life Insurance Company occurred in 1998 for a five-year period ending December 31, 1997. During this subsequent examination, the examination work papers for the prior examination (as of December 31, 1992) were destroyed. Because of the volume of examination work papers, it is the department’s practice for the subsequent examiner to destroy the prior work papers. The subsequent examiner did retain the 1993 custodian affidavit forms. Other than these forms and the examination report, little documentation exists for the examination for the three-year period ended December 31, 1992.

### Altered Custodian Affidavits Were Not Questioned

The Division of State Audit reviewed the custodian affidavits and determined that on August 17, 1993, Mr. Mark Jaquish, Examiner In-charge of the examination, received the custodian affidavit forms A, B, and C from Liberty National Securities, Inc. (see Exhibit A). These affidavits were allegedly signed by “William Kok,” as president of the brokerage firm located in the State of Ohio on July 15, 1993. The forms were altered in that asterisks were placed throughout the documents by the words “bank” or “banking institution.” At the bottom of each page of the three affidavits the respondent typed a sentence that stated whenever the words “bank” or “banking institution” appeared in the document, “securities brokerage firm” should be substituted. In addition to the altered wording on the affidavits, the fact that all three forms were submitted should have raised some question. With the majority of Franklin American Life Insurance Company’s funds allegedly with the brokerage firm invested in the same government securities, only Form C would have been applicable, had a custodian bank been involved. However, the submission of the two inapplicable forms was not questioned.

### Examiner's Statements Regarding Examination

Mr. Jaquish was interviewed by staff of the Division of State Audit on October 21 and November 2, 1999. Mr. Jaquish stated that he did not recall whether the physical custody of Franklin American Life Insurance Company's bonds was recognized as a problem during the examination. He stated that if there had been a custody issue, then it would have been noted in the examination report.

### Examination Report

The report for the company was issued on April 15, 1994, and stated that the customary insurance examination procedures promulgated by the National Association of Insurance Commissioners (NAIC) had been followed in connection with the verification and valuation of assets of the company. The report stated that Franklin American Life Insurance Company had admitted assets of \$28,204,808 as of December 31, 1992. The capital and surplus in excess of liabilities was presented as \$3,425,247. The report did not mention an improper holding of securities or the lack of a custodial agreement.

### Examiner's Statements Regarding Examination Failures

Mr. Jaquish acknowledged that only a bank would be considered a proper custodian of such securities and that the custodian affidavits he received from Liberty National Securities, Inc., were not sufficient to evidence a proper custodial arrangement. Mr. Jaquish stated that the required proper custodian would have been a banking institution and that the examiners had failed to note the noncompliance of the company in regard to the requirement. Mr. Jaquish also stated that no other examiners noted this particular irregularity during the examination. Mr. Jaquish stated that although he recalls another examiner working on the investment section during the examination, he did not recall the extent of his own involvement with this section. Mr. Jaquish also acknowledged that he had not questioned the submission of all three custodial affidavit forms. He acknowledged that the examiners, including himself, should not have accepted the altered affidavit forms and that additional procedures should have been conducted. He also acknowledged that the assets held with the brokerage firm should not have been admitted in the examination report as having been verified. Furthermore, Mr. Jaquish stated that, in his opinion, these issues were so problematic that, if they had been noted at the time, they would have most likely been referred for resolution to the Commissioner's Office.

### Assets Should Not Have Been Included Due to Improper "Holdings"

Had the examiners noted the improper holding of securities, the securities held by Liberty National Securities, Inc., would not have been admitted as part of the Franklin American Life Insurance Company's assets. Given these circumstances (with admitted assets less than liabilities), the company would have been considered insolvent at that time because liabilities exceeded assets by approximately \$21 million.

### Examiners' Statements on Review of Examination Work

Mr. Jaquish confirmed that he had written his initials and date on the three affidavits, noting that he had received them on August 17, 1993. Mr. Jaquish also confirmed he had written his initials and date on the three affidavits on October 14, 1993. According to Mr. Jaquish, he may have been reviewing work papers in October 1993 and initialed and dated the affidavits to signify his review. Other than Mr. Jaquish's review, it does not appear that these critical documents were reviewed by Mr. Jaquish's supervisors. At the time of the examination, a supervisory review was only performed on the issues presented in the examination report. Under these procedures, the work papers relating to the securities were not reviewed at a higher level because the examiners failed to note the improper holding of securities by a brokerage firm, and thus, this information was not included in the examination report.

### Lack of Scrutiny of Brokerage Firm

It should be noted that the insurance division examiners, as part of this examination of Franklin American Life Insurance Company, did not check on Liberty National Securities, Inc., or on the signee of the custodial affidavit with the securities section of the department. As previously mentioned, in inquiring about Liberty National Securities, Inc., Mr. Lovelady determined the company did not appear to have sufficient financial standing to be held liable for the alleged \$23 million from Franklin American Life Insurance Company.

### Information that Could Have Been Obtained Regarding the Brokerage Firm

Additional information that could have been obtained from the department's security division included Liberty National Securities, Inc.'s audited financial statements that did not disclose the firm's liability of holding securities for its clients (including the securities of Franklin American Life Insurance Company); the firm's registration with the security division that did not indicate the firm was trading in government securities; and the security division's records that did not reflect a New York address as shown on the broker's trading confirmations and on the custodial affidavit.

### Unregistered Agents of Brokerage Firm

*Tennessee Code Annotated*, Section 48-2-109, states that it is unlawful for any person to transact business from or in this state as a broker-dealer or agent unless such person is registered as a broker-dealer or agent. There are exceptions to this statute, and Liberty National Securities, Inc., had a viable exemption in that it was only doing business with an institutional investor (a bank or insurance company). However, once the brokerage firm registers as a broker-dealer, then the statute requires the agents associated with that firm to be registered, according to Mr. Larry Burton, Chief of Broker-Dealer Registration, Department of Commerce and Insurance. According to documents filed with the department's security division, Liberty National Securities, Inc., was registered with the division as a broker-dealer, having been so registered since 1991.

However, the agent allegedly conducting the trades on behalf of Franklin American Life Insurance Company was not registered. Inquiries into Franklin American Life Insurance Company regarding the names of the associated agents the company dealt with would have revealed that the agent, Mr. Eric Stevens, whom Mr. Hackney allegedly dealt with, was not registered.

**(1993-1994) INSURANCE DIVISION STAFF FAILED TO INVESTIGATE THE UNUSUAL VOLUME OF REPORTED TRADING OF SECURITIES AND UNUSUAL RETURNS REPORTED ON INVESTMENTS**

Required Monthly Reporting

During calendar years 1993 and 1994, various financial transactions of Franklin American Life Insurance Company were reported to Insurance Division staff on monthly, quarterly, and annual bases. Monthly reporting by insurance companies is not a routine requirement but was requested by the department because of the poor financial condition of the company in 1990.

Unusually High Volume of Reported Trades

This financial information revealed a volume of security trades that is uncommon to insurance companies. In addition, the reported return on Franklin American Life Insurance Company's investment portfolio for calendar year 1993 was unusually high (20%) for a portfolio consisting mainly of United States Treasury bonds and notes. Furthermore, in the quarterly financial reporting to the department for the quarter ended June 30, 1994, the company reported \$1.5 million net unrealized loss on investments. This information was clearly inconsistent with the other filings. Yet, the staff involved in analyzing this information did not take any further steps toward understanding the unusual phenomena regarding the volume and reported returns on investment trades.

Unusual Losses Reported on Trades

From the documentation in the department's files maintained on the company, staff noted their concerns over the unrealized losses relative to the negative effect on capital and surplus, and these concerns were forwarded to the higher-level staff of the division. This prompted a meeting with company officials and Mr. Bill Hosea. Although the results of the meeting were not documented, Mr. Hosea recalls meeting with officials of Franklin American Life Insurance Company sometime in late calendar year 1994 regarding their trading strategy and the unrealized losses resulting from that strategy.

Lack of Due Diligence on the Part of the Financial Affairs Director and Division Staff

Mr. Hosea stated that the company's strategy, as explained to him by Mr. Hackney, was that its broker was able to profit simply by trading government securities and was sharing this profit with the company. The director failed to further investigate

the responses he received from company officials. Although the director and division staff did not have the expertise in security trading to determine whether the company's alleged trading strategy was viable, the director was satisfied with the explanations from company officials and no further investigative steps were taken. The lack of due diligence on the part of the division staff to understand the reported financial activities of the company resulted in extending the period that Mr. Frankel's scheme went undetected.

#### Desk Examinations

The insurance division staff routinely conducted desk examinations of quarterly and annual unaudited financial statements and annual CPA audited financial statements. During these desk examinations, division staff analyzed the financial data through ratios specifically targeted to identify deficiencies in reserves and liquidity, and to identify emerging trends. Because of Franklin American Life Insurance Company's insufficient capital and surplus reserves before the Thunor Trust acquisition of the company, the department required the company to submit financial statements on a monthly basis. This additional requirement was removed in September 1995.

#### Investment Activity in 1993

The monthly and year-end 1993 annual financial statements for Franklin American Life Insurance Company included information that the company turned over its entire investment portfolio almost 34 times. Although the financial statements do not include each investment transaction, it appears that the company purchased and sold approximately \$25 million in United States Treasury Notes, series 1994, seven times during the fiscal year. In addition, the company purchased and sold approximately \$30 million in United States Treasury Bonds, Series 2021, 27 times during the company's fiscal year. No other investment instruments were reported for the period. The bonds and notes were acquired at a premium and were paying an annual effective rate of return of approximately 4.5 percent. These treasury bonds and notes were interest-bearing instruments. In order to achieve the effective rate of return from the interest paid, the bonds had to be purchased and held. Therefore, such investments are generally held long-term. These types of investments are often purchased by insurance companies because the bonds and notes fit their needs, which are generally investing life insurance premiums to ensure that the company has adequate funds in the long-term when a majority of the claims are filed by policyholders. Such investments also have relatively low risk, compared to corporate bonds or stocks, and are very liquid.

#### Investment Activity in 1994

Franklin American Life Insurance Company was, in essence, reporting that it was not buying and holding government securities but rather that it was buying and selling the same bonds and notes over and over again. In addition, the company reported returns of 20 percent, basically from the profits of these bonds and notes transactions. In the company's fiscal year 1994, the reported turnover rate of treasury bonds and notes of approximately \$38 million allegedly owned by Franklin American Life Insurance

Company increased to 170. In essence, the company was allegedly buying and then selling its entire investment portfolio (effectively, one “turnover”) almost every two days.

This dramatic change from a portfolio turnover rate of 34 in 1993 to a rate of 170 in 1994 did not trigger any further scrutiny of the company’s trading strategy by division staff or department officials. The desk examinations of the company’s financial statements were not designed to identify changes in turnover rates as problematic, in part, because this type of volume in trades was very uncommon for insurance companies. Also, desk examinations, in terms of investments, appeared to focus on the calculation of deficiencies in surplus reserves and whether the company had exceeded limitations on different types of investment vehicles, rather than on extreme changes in items, such as portfolio turnover.

#### Financial Affairs Director’s Statements Regarding Trading

In interviews with insurance division staff, they concurred that this trading strategy allegedly used by Franklin American Life Insurance Company was unusual. In fact, division staff stated that they were not aware of any other insurance companies with a similar trading strategy. Mr. Hosea stated that the division staff knew about the unusually high volume of trading in 1994. However, he stated that this type of trading was not prohibited by statute and did not appear to be detrimental to the company’s financial position. Mr. Hosea stated that after speaking with Mr. Hackney, President of Franklin American Life Insurance Company, he was satisfied with Mr. Hackney’s explanations regarding the company’s trading strategy. Mr. Hosea admitted that he did not have the expertise in securities trading to determine whether the company’s alleged trading strategy was viable.

#### Company’s Explanation of Its Trading Strategy

According to Mr. Hosea, he met with Mr. Hackney sometime in late 1994. Mr. Hosea stated that Mr. Hackney told him that the company’s strategy was to trade government securities on a frequent basis to take advantage of interest rate fluctuations. Mr. Hosea stated that Mr. Hackney told him the company could make a profit on daily trades. This profit could be gained because the broker with Liberty National Securities, Inc., would allegedly share half of the difference between the discounted bond prices available to him and the prices the company would pay for the bonds if it had used a national broker to trade the securities. Mr. Hosea stated that he did not have any specific knowledge of how this difference allegedly transpired other than what Mr. Hackney explained to him. According to Mr. Hosea, Mr. Hackney stated that the company would usually receive one basis point, equal to 1/32 of a bond’s unit price, in profit from each trade. Mr. Hosea stated that Mr. Hackney told him that he would call someone in England at approximately 11:00 p.m. each night to determine the overseas bond market and expected interest rate changes relative to this market. According to Mr. Hosea, Mr. Hackney stated that the company was able to use this overseas market information and make a profit by trading its securities on a daily basis. Mr. Hosea stated that he was satisfied with Mr. Hackney’s explanations and therefore did not question the rationale of

the company's trading strategy, and he did not seek any assistance from anyone else within the department.

#### Promise of Additional Capital by Company Official

Mr. Hosea also stated that he and Mr. Hackney discussed Mr. Hosea's concerns over the company's unrealized losses and their negative effect on capital and surplus. According to Mr. Hosea, Mr. Hackney promised that the Franklin American Corporation would, to his knowledge, provide the company with an additional \$9 million. According to Mr. Hosea, this infusion of additional capital never occurred.

#### Financial Affairs Director's Statements Regarding Discussion With Legal Staff

Mr. Hosea stated that after the meeting with Mr. Hackney, he spoke with the legal staff of the department, at that time, about Franklin American Life Insurance Company's trading strategy. Although Mr. Hosea did not recall the department attorneys he spoke with, he stated that they determined that Franklin American Life Insurance Company's trading strategy was not in violation of the law and there was apparently no legal remedy available to the department to prevent the company from such trading activities. None of the current or former attorneys of the department recall speaking with Mr. Hosea on this matter.

#### Financial Affairs Director's Failure to Contact a Securities Expert

When Mr. Hosea was asked by the auditors if he had contacted the department's Securities Division or sought advice from a securities expert, Mr. Hosea stated that, at the time, he did not consider making such inquiries. If Mr. Hosea or other division staff had contacted the securities division within their own department or an individual experienced with the trading of government securities, they would have determined that the company's alleged trading strategy was not viable.

#### State Expert's Opinion

To determine whether the trading strategy purported by Mr. Hackney was viable, the auditors discussed the matter with representatives of the Tennessee Consolidated Retirement System. Mr. Jeffrey Bronnenberg, Director of Fixed Income, stated that such a trading strategy was not rational. He stated that information from overseas markets can be useful but not consistently when trading on a daily basis, as Franklin American Life Insurance Company allegedly did. Mr. Bronnenberg stated that if the company was playing the market to take advantage of changes in interest rates, the company's trades should have included purchases of a variety of short-term and long-term securities, depending upon the direction of interest rates. In his opinion, because the company's trading involved the trading of the same government bonds and notes, it was inconceivable that any profits could be made when interest rates were fluctuating both negatively and positively, relative to that bond, on a frequent basis.

In terms of the alleged discount received by the company from its broker at Liberty National Securities, Inc., Mr. Bronnenberg stated that although there are pricing differences on bonds available to broker-dealers in the dealer market, the government security market has many sophisticated dealers. He stated that in purchasing government bonds that are not held in the inventory of the usual dealers he trades with, he would contact four or five dealers to get the best deal. In the alleged trading of Franklin American Life Insurance Company, Liberty National Securities, Inc., would not have had the millions of government securities traded in its inventory and therefore would have been required to obtain the securities in this dealer market. Mr. Bronnenberg stated that it was inconceivable that the Liberty National Securities, Inc., broker could consistently receive better prices than the other dealers could.

**(1995-1996) INSURANCE DIVISION STAFF FAILED TO PROPERLY NOTE THE COMPANY'S DISCLOSURE OF INVESTMENTS HELD WITH A BROKERAGE FIRM AS A NONCOMPLIANCE ISSUE**

**Desk Examinations Failed to Note Improper "Holdings"**

During the insurance division's routine desk examinations of the annual financial statements received from Franklin American Life Insurance Company for the years ended December 31, 1994 and 1995, staff failed to properly note the company's noncompliance with the department's rule requiring insurance companies' securities to be held by a bank or clearing corporation through a custodian bank. Prior disclosures had reported to the department that securities were held by the company. (See Exhibit B for the company's 1993 disclosure.) For the first time, company representatives indicated in the interrogatories, which were an integral component of their 1994 annual financial statements, that the securities were not in possession or exclusive control of the company but were "held by broker in street name" (see Exhibit C). The same disclosure was made by company representatives in the interrogatories accompanying their 1995 annual financial statements.

However, on these two different occasions, the insurance division analytical reviewers incorrectly marked the desk examination checklists and indicated that the company represented that it did hold assets in its exclusive control (see Exhibit D). The desk examinations, although limited in scope, were designed to prompt further reviews if disclosures were made that securities were not in control of the company. Although the checklists used by the analyst do not specifically address the custodial agreement, further inquiry into the holding of the insurance company's securities by a brokerage firm should have been prompted by the correct indication on the checklist and should have brought the custodial agreement issue forward. The incorrect marking of the desk examination checklists by division staff failed to trigger any further review. The failure of staff to properly note the company's disclosures resulted in extending the period that Mr. Frankel's scheme went undetected.

## Desk Examinations and Supervisory Reviews

According to Ms. Kathy Fussell, Chief Analyst during the period under review, the checklists used by the insurance division consist of questions requiring the analyst to review the company's financial statement and respond either "yes" or "no," and enter values as they relate to the company's solvency. She stated that sometimes these checklists are initially prepared by interns or support staff. However, in such cases the work is reevaluated by an analytical reviewer. Ms. Fussell stated that depending on the question, either the "yes" or "no" columns contain an asterisk. If that column with the asterisk is checked by an analytical reviewer, she stated that this prompts her to perform further reviews. Ms. Fussell stated that her reviews consist of reviewing issues indicated by columns containing the asterisk and exceptions written. Ms. Fussell stated that her reviews did not involve checking the analysts' work and would not have extended beyond the exceptions noted by the analysts. Ms. Fussell also stated that after completing her review, she initialed and dated the checklist.

### 1994 Annual Statements

The unaudited 1994 annual financial statements of Franklin American Life Insurance Company were received by the insurance division on February 25, 1995. The corresponding checklist with preprinted questions indicated that Mr. Dan Graham, then an analytical reviewer with the division, performed the analysis of the financial statements, which included the interrogatories answered by officials from Franklin American Life Insurance Company. This checklist incorrectly indicated that the company had exclusive control of its securities when, in fact, the company had reported that its securities were "held by broker in street name." The present whereabouts of Mr. Graham were unknown by the division staff and he was not interviewed as part of this review.

### 1995 Statements

The unaudited 1995 annual financial statements of Franklin American Life Insurance Company were received by the insurance division on February 29, 1996. The corresponding checklist with preprinted questions indicated that Mr. Billy Williams, then an analytical reviewer with the division, performed the analysis of the financial statements, which included the interrogatories answered by officials from Franklin American Life Insurance Company. This checklist incorrectly indicated that the company had exclusive control of its securities when, in fact, the company had reported that the securities were "held by broker in street name." Although Mr. Williams did not correctly answer the corresponding question on the checklist during his review in 1996, he did write in a comment that the securities were "held by broker in street name" (see Exhibit E).

### Analyst's Comment Was Not Reviewed

Although Mr. Williams' written comment was not placed in the exceptions section of the checklist that would routinely have been part of Ms. Fussell's review, it is clearly noticeable and should have been questioned by Ms. Fussell and Mr. Hosea as part of their review. Both Ms. Fussell and Mr. Hosea initialed and dated the checklist in question, to signify their completed reviews. According to Ms. Fussell and Mr. Hosea, they did not notice Mr. Williams' written comment. They stated that had they noticed it, they would have questioned the company's disclosure.

### Analyst's Statements Regarding His Desk Examination

In an interview with state auditors on March 1, 2000, Mr. Williams stated that he started working in the insurance division in November 1995 as an analytical reviewer. He stated that he received little guidance as to how he was to perform the reviews of unaudited annual financial statements. He stated that at the time he analyzed the 1995 annual financial statements of Franklin American Life Insurance Company, he would not have known that investments of insurance companies domiciled in Tennessee were required to be held with a bank or clearing corporation through a custodial bank.

Regarding the incorrectly answered checklist item corresponding to the company's control of its securities, Mr. Williams stated that he brought up this issue to his supervisor during his review and was told that, although the brokerage firm held the securities, this did not mean that the company did not have control of the securities. Mr. Williams stated that there was no question in his mind that he brought this issue forward and stated that he had been instructed to answer the question in opposition to what was reported by Franklin American Life Insurance Company officials. Mr. Williams stated that, although he could not specifically recall who instructed him to answer the question this way, it was most likely Ms. Fussell. However, he could not rule out being instructed by Mr. Spann or Mr. Hosea on this matter.

### Supervisors' Statements

In the review of this matter, Mr. Williams' statement regarding this checklist instruction could not be verified. In addition, it appears that Mr. Williams misunderstood the checklist question or misunderstood the instructions he received. When questioned about the alleged instructions to Mr. Williams, Mr. Hosea, Mr. Spann, and Ms. Fussell all stated that Mr. Williams was not instructed to answer the checklist question in opposition to what was reported by the company. They also stated that the procedures followed by the insurance division were to answer the checklist questions as reported by the company and then to address any exceptions in the narrative section of the checklist.

According to Ms. Fussell, checklists should follow the company's interrogatories even though the information may conflict with other items reported by the company. She stated that the proper place to address such conflicting items or other items such as securities being held by broker would be in the narrative section of the checklist.

In discussing the issue of control of assets with Mr. Williams, he stated that he regarded the question of control in the legal sense rather than as a physical control question. According to Mr. Williams, the fact that the securities are held with a brokerage firm does not mean that the insurance company does not have control over its assets with that brokerage firm. However, the checklist question is referring to the physical possession of the assets, according to Mr. Hosea. In this case, the question of control would be correctly answered in the negative if those assets were with a bank, a clearinghouse, or a brokerage firm.

#### Analyst's Resignation and Subsequent Employment With Company

It should be noted that soon after he completed the desk evaluation of Franklin American Life Insurance Company in early March 1996, Mr. Williams resigned his position with the Department of Commerce and Insurance and went to work for the company. In an interview with auditors, Mr. Williams stated that he had met Franklin American Life Insurance Company's Treasurer, Ms. Judy Lowrey, at conferences and annual Christmas parties. He stated that during his employment with the department, he had also discussed various financial issues with company officials and became familiar with their financial issues in a general sense. Mr. Williams stated that because he was already familiar with the company and its officials, he decided to take the assistant treasurer position with Franklin American Life Insurance Company when it became open in June 1996. During this review, no evidence was found that suggested any impropriety in Mr. Williams' acceptance of the assistant treasurer position with Franklin American Life Insurance Company.

#### ***(1996) THE UNDOCUMENTED TARGET EXAMINATION OF THE COMPANY'S TRADING ACTIVITIES FELL SHORT OF GOALS AND STANDARDS***

##### Unusually High Volume of Trades Reported for 1995

During 1996, the department received the unaudited 1995 annual financial statements of Franklin American Life Insurance Company that indicated that the volume of trading of the company's securities had increased over the prior year. In fact, the company reported that its entire portfolio had "turned over" 245 times during 1995. In light of this unusual activity for an insurance company, Ms. Fussell had requested that the company report every security transaction that had occurred in its quarterly financial statements, although this was not specifically required by NAIC regulations. Rather than complying with the request, the company responded by a letter dated July 16, 1996. The letter was from the company's assistant treasurer, at that time, Mr. Terry Porter, and stated that it was the company's investing philosophy to invest in government securities and trade every day. The company's response also stated that it realized that this trading activity may be considered unusual, but it had proven to make the company stronger financially.

### “Target Examination” Requested

With these two issues in mind, on September 25, 1996, Mr. Hosea instructed two analysts to perform a “target examination” of Franklin American Life Insurance Company. Target or special examinations are defined in the *NAIC Examiners Handbook* as examinations with limited objectives and procedures. According to Mr. Hosea, at that time he was concerned that the company might be “short selling” government securities. Short selling is a term referring to the sale of investment instruments without ownership in anticipation of a fall in prices. Mr. Hosea stated that this type of risky trading activity is prohibited for insurance companies. The risk involved with short selling is that a condition of the contract the seller enters into requires the seller to purchase the security back at a later date, at which time the security’s price may have increased.

### “Target Examination” Procedures Were Not Followed

After a one-day on-site review of a limited number of trading confirmations and monthly statements from the brokerage firm by Ms. Fussell and Mr. Larry Knight, Analyst, the two verbally reported to Mr. Hosea that it did not appear to them that the company was short selling. However, the work they performed was not supported by any documentation or any report on the procedures performed and their findings as required by the *NAIC Examiners Handbook*.

According to the two analysts, neither analyst had the securities expertise to determine whether the company’s explanations were reasonable for the high volume of trades. In addition, the two analysts stated that other critical questions regarding the company’s trading strategy, whether the company was paying any commissions, and whether the company had a proper custodial agreement in place with a bank were brought up for the first time during this target examination by the analysts. However, these issues remained problematic afterwards because the analysts failed to obtain the necessary documentation to support management’s assertions. The analysts also failed to obtain a reasonable understanding of the company’s unusual trading strategy. A diligent review into this issue would have determined that the company’s purported trading strategy was not viable. Although numerous areas of concern existed and warranted the target examination, it appears that it was another missed opportunity for division staff to detect Mr. Frankel’s scheme.

### Authorization of “Target Examination”

Under a Certificate of Authority, the department may conduct “target examinations” (also referred to as special examinations) if the Commissioner deems it necessary. The Commissioner at that time, Mr. Douglas Sizemore, authorized a target examination of Franklin American Life Insurance Company on September 25, 1996. With the unusual volume of trading allegedly occurring and lack of detailed trading transactions reported to the division, Mr. Hosea chose Ms. Fussell and Mr. Knight and instructed them to perform a target examination of the company. The decision concerning whom to send was apparently based on available senior staff. However, both

Ms. Fussell and Mr. Knight stated that they did not have extensive knowledge or experience in securities needed to ascertain whether the company's explanations were reasonable.

#### Analysts' Statements Regarding "Target Examination"

According to Ms. Fussell, their examination was completed in one day. Ms. Fussell also stated that the examination did not include planning or discussions with legal or securities division staff. Both analysts recall that the information from the trading confirmations and monthly statements was matched with the transactions reported in the financial statements. However, they stated that the scope of their examination was limited in that the company did not give them access to all of the earlier trading confirmations. Based on the trading confirmations they reviewed, the analysts stated that it appeared the company had purchased the securities before the securities were sold.

#### Analysts' Discussions With Company Official

Both analysts stated that they did not have the expertise in securities to adequately review the company under the circumstances. Therefore, the two analysts tried to obtain some answers from Mr. Hackney to assist them and the insurance division to understand what the company was reportedly doing. Both analysts stated that while they were conducting this examination, Mr. Hackney was present and was asked questions, including the rationale for the company's trading strategy. According to the two analysts, the answers given by Mr. Hackney regarding the company's trading strategy did not appear reasonable. In addition, according to Mr. Knight, they asked Mr. Hackney if Liberty National Securities, Inc., was holding the securities and whether there was a custodial agreement with a bank. Mr. Hackney reportedly stated that the brokerage firm was just trading the government securities and that because of the frequency of the trades, the securities were never actually "held." According to both analysts, Mr. Hackney stated that because the government securities were being traded almost on a daily basis, the requirement for a custodial agreement was not applicable.

#### "Target Examination" Was Not Documented

No documentation was found in regard to the target examination. The *NAIC Examiners Handbook* states that reports on target examinations "should describe, at a minimum, the limited objective of the examination, the overall scope of procedures applied, and the examiner's findings from performing those procedures." Although the target examination of Franklin American Life Insurance Company was limited, it appears that there are no exceptions in the handbook for these measures and that the examination guidelines were violated in that the work of the analysts was not documented or properly reported. According to Mr. Hosea and the two analysts, this visit to the company to check on the trading confirmations and monthly statements from Liberty National Securities, Inc., was not a "true" target examination. According to the insurance division staff, two or three target examinations are performed each year on average and can require examiners to spend up to three months to complete. According to the insurance

division staff, the division's lack of staffing prevented them from conducting a "true" target examination of Franklin American Life Insurance Company at that time.

#### Other Issues Missed in "Target Examination"

The analysts on the examination also appear to have missed a central issue regarding the commissions on the trades. Frequent trading is indicative of a broker scheme referred to as "churning." In a churning scheme, the broker makes excessive and frequent purchases and sales primarily to generate commissions. Both analysts stated that they were concerned that the broker may have been churning Franklin American Life Insurance Company's portfolio to generate commissions for the brokerage firm, but neither recalled determining whether the commissions appeared reasonable. Without documentation of work performed on the target examination, the extent and findings of their examination into this issue could not be determined.

#### Analysts' Recommendations

After returning to the department, the analysts recommended that a securities expert look at the company. A meeting between department officials and Mr. Hackney was also recommended because a reasonable understanding of the company's trading strategy had not been obtained by division staff. These recommendations were made to Mr. Hosea and to Mr. Spann. Mr. Hosea and Mr. Spann confirmed that they had received these recommendations. In regard to this matter, Mr. Hosea stated that obtaining an expert was discussed but no actions were taken because the procurement of such services was not within the division's budget. Mr. Knight also stated that the analysts also mentioned the lack of a custodial agreement to Mr. Hosea and Mr. Spann. However, the division staff failed to take appropriate action regarding these matters until Mr. Lovelady's services as a contract examiner were available in August 1998.

It is clear from this chronology that Ms. Fussell and Mr. Knight failed to complete a proper target examination, as was required by the Commissioner's authorization of a target examination. Moreover, Mr. Spann and Mr. Hosea failed to ensure that a proper target examination was completed and also failed to understand and respond timely to the issues raised by the analysts. These multiple failures exemplify the serious lack of due diligence by division staff.

#### **(1996-1998) FINANCIAL AFFAIRS DIRECTOR'S LACK OF ACTION**

During the period between the September 1996 target examination and August 1998, when Mr. Lovelady began the comprehensive examination of Franklin American Life Insurance Company, the insurance division's analysts recommended that a securities expert review the trading activities reported by the company and that an examination of the company be initiated immediately. However, Mr. Hosea did not take steps to procure the services of an expert, nor did any division staff seek to investigate Liberty National

Securities, Inc., or seek expert advice from the department's Securities Division or other experts on the unusual trading activities of Franklin American Life Insurance Company.

Mr. Spann obtained the services of Mr. Lovelady to conduct the statutorily required five-year examination, but Mr. Lovelady was not available until August 1998. It should be noted that because of the division's concerns, Mr. Hosea did request that the company increase its fidelity bond coverage from \$5 million to \$50 million to protect policyholders and shareholders against losses due to dishonest acts of its employees. This additional coverage was effected on May 15, 1998, and a proof of claim on the bond coverage has been filed.

In regard to a review of the company's trading activities by an expert, Mr. Hosea stated that the department historically did not budget funds for the hiring of experts to perform such reviews. However, Mr. Hosea admitted that he had not brought the division's concerns and the need to hire an expert to Mr. Sizemore, then the Commissioner, or to Mr. Nevins, the Assistant Commissioner, during the period. According to Mr. Sizemore, had he been aware of the division's concerns, he would have approved the hiring of a securities expert. This lack of action on the part of the insurance division regarding the warning signs (unusual trading) was the most serious of the inadequacies addressed in this report.

In addition, the division received Franklin American Life Insurance Company's account statements relating to their funds with Liberty National Securities, Inc., that clearly indicated that the company's securities were held for 30 days by the brokerage firm without any trades. The division failed to note this improper holding of securities without a proper custodial agreement in place. The holding of securities without a proper custodial agreement violated the *Rules of Department of Insurance* and was not enforced. The division staff's lack of action resulted in extending the period that Mr. Frankel's scheme went undetected.

#### Reasons for Lack of Action

The reasons that Mr. Hosea did not take appropriate actions, including his failure to share the insurance division's concerns about the company with upper management, are unclear, considering the known facts at this time regarding Mr. Frankel's scheme. However, according to Mr. Hosea, from his perspective, the issues involving Franklin American Life Insurance Company dealt with compliance with regulations rather than indicators of fraudulent activity. During 1997 and 1998, the insurance division's staff had concerns about other insurance companies that had known insolvency issues. In contrast, Franklin American Life Insurance Company's financial statements during this two-year period reported its reserves were well above the minimum requirements, and thus the company appeared solvent. Considering these facts and the company's small size in comparison with many of the insurance companies the division was charged to regulate, Mr. Hosea contends that Franklin American Life Insurance Company's unusual trading strategy was not their most critical issue during this time. However, an analyst

and the chief analyst on checklists and memorandums had considered the company's trading strategy a critical issue.

Additionally, the insurance division's role as regulator has historically focused on the solvency of insurance companies conducting business in Tennessee rather than on indicators of fraud. This role is largely based on state statutes that require that insurance companies maintain a minimum of \$1 million in capital and an additional \$1 million in surplus capital, and the NAIC guidelines that include procedures and analyses of financial ratios and indicators centered on the solvency of insurance companies.

### Regulatory Considerations

The state statutes also provide the Commissioner with varying degrees of sanctions when an insurer's financial condition is problematic. However, according to Ms. Jeanne Barnes Bryant, Chief Operating Officer of the Tennessee Receiver's Office and former Chief Counsel for the Insurance Division with the department in 1986, such sanctions can be difficult to enforce if the insurance company does not consent. Ms. Bryant, who is currently working on the liquidation of Franklin American Life Insurance Company, stated that the Chancery Courts have required sufficient evidence of insolvency in contested cases before the department was successful in convincing the court to grant a sanction placed on an insurance company. Based on interviews with the department staff and considering the emphasis placed on the issue of solvency by statute, it appears that unless there was clear and sufficient evidence of insolvency, the department was of the opinion that taking any action was unwarranted.

### Staff Recommend Action

However, the lower-level staff of the division continued to bring their concerns about the company to Mr. Hosea's attention. On December 3, 1996, in a memorandum, the two analysts that conducted the target examination, in September 1996, recommended that the division meet with company officials regarding the unusual trading. After a meeting with company officials on May 23, 1997, Mr. Spann questioned whether the assets could be admitted in the company's financial statements since the money was in control of the brokerage firm. According to Mr. Spann's June 19, 1997, memorandum regarding the meeting, Mr. Hosea was considering whether trading transactions were appropriate. On August 11, 1997, Mr. Robert Ribe, Analyst, recommended in a memorandum to Mr. Hosea, Mr. Spann, and Ms. Fussell that the division perform an examination of the company as soon as possible. The quarterly statements of the company, at that time, reported over \$1.6 billion in trades of government securities for the period April 1 through June 30, 1997. After receiving Mr. Ribe's memorandum, Ms. Fussell recommended that the division meet to discuss the investments of Franklin American Life Insurance Company again. Ms. Fussell also requested that the company supply the division with a complete listing of all trades for the quarter ended June 30, 1997. On May 12, 1998, Mr. Ribe wrote a memorandum to Mr. Spann suggesting a manual verification of the company's government securities.

### Financial Affairs Director's Statements on Potential Fraud

According to Mr. Hosea, he believed that the reported assets (securities) of Franklin American Life Insurance Company existed. He stated that the division relied upon the confirmations from the brokerage firm during the division's examination conducted in 1993 and relied upon the audited financial statements they received every year for Franklin American Life Insurance Company. He stated that although they usually rely on confirmations from banks, the division has accepted confirmations from brokerage firms regarding transactions, which had not been completed at year-end. Therefore, according to Mr. Hosea, the issue was not whether the assets of Franklin American Life Insurance Company had been stolen by the brokerage firm, but rather the issue was centered on compliance.

### Company's Position Regarding the Department's Rule on "Holdings"

Mr. Hosea also stated that Mr. Hackney had argued that since Franklin American Life Insurance Company traded frequently, neither the company nor its brokerage firm could take physical possession of the governmental bond certificates and therefore were technically never "held." The reason physical custody could not occur is that typically, in stock and bond trading, a transaction from the initial purchase to the delivery of the certificates to the buyer requires a three- to five-day period. Therefore, according to Mr. Hackney, Franklin American Life Insurance Company's frequent trades did not allow for the company or its broker to take physical possession, as the government securities were sold almost daily. According to Mr. Hosea, Mr. Hackney also argued that the company's trading strategy was not prohibited by Tennessee law. The company presented the rationale that its lawful trading strategy prevented its compliance with the department's regulatory holding requirement, and therefore the company should be excepted from that requirement. Otherwise, according to the company's presentations, the state regulators would be improperly restricting its investment practices.

### Financial Affairs Director's Statements Regarding Legal Issues

Mr. Hosea stated that none of the statutes or NAIC guidelines prohibited the frequent trading of securities. He also stated that in regard to the noncompliance issue of the brokerage firm holding the securities, he brought this issue before the legal staff, at that time, and they were of the opinion that the department's regulations were not applicable, that securities being traded on a daily basis did not fit the requirements of the definition of being "held" as stated in the department's regulations. Mr. Hosea did not specifically recall which attorneys held this opinion.

At the time, attorneys Ms. Jennifer Loyd and Ms. Martha Carol Holland were assisting the insurance division but have since left the department. They were both contacted during this review but did not recall this matter being brought to their attention or rendering an opinion on this issue.

### Financial Affairs Director's Lack of Communication

Mr. Hosea stated that because the problems with the company dealt with compliance issues rather than fraud, he did not inform the Commissioner or the Assistant Commissioner. He also stated that rather than taking further actions, the division just monitored the company's bond trading.

### Analyst's Request for Detailed Listing of Trades

In August 1997, as part of this monitoring of Franklin American Life Insurance Company's government securities trading, Ms. Fussell requested the entire listing of trades conducted during the three-month period April 1 through June 30, 1997. According to Ms. Fussell, a company official hand-delivered the account statements from Liberty National Securities, Inc., which showed all of the activity for the three-month period. The information on these account statements was not analyzed.

The account statements from Liberty National Securities, Inc., for Franklin American Life Insurance Company for the period April 1 through May 30, 1997, show a pattern of the sale of approximately \$53 million in bonds each day and then the purchase of those same issue of bonds later the same day. However, the account statements show that from May 30 through June 29, 1997, no trades were indicated. According to the statements, on May 30, 1997, the company purchased approximately \$53 million in U.S. Treasury Bonds, Series 2021, at 8.00%. The statements also indicate that these bonds were not sold until June 30, 1997, for approximately \$54.5 million. Therefore, the division should have been aware that the bonds were being held during that 30-day period by Liberty National Securities, Inc.

### **(1999) DESPITE WARNING SIGNS, THE THEN COMMISSIONER ALLOWED AN ADDITIONAL 60 DAYS OF TRADING**

After a February 2, 1999, meeting with Franklin American Life Insurance Company representatives and department staff and officials, the Commissioner, at that time, decided to allow the company to reconvene its trading of securities with Liberty National Securities, Inc., in "street name" for an additional 60 days. Although this decision was contrary to department rules, which required a custodial agreement with a bank for the holding of insurance company securities, in the Commissioner's opinion, it gave Franklin American Life Insurance Company a reasonable period in which to comply with the rule. However, this decision was made without the full facts and information available at the time.

### Critical Information Regarding Brokerage Firm Is Forwarded to Department Officials

Prior to the Commissioner's decision, unsettling information regarding the brokerage firm's registration and net worth was obtained by Mr. Lovelady, contract examiner, as part of his examination of Franklin American Life Insurance Company. Mr.

Lovelady contacted Mr. Spann on January 27, 1999, and shared this information regarding Liberty National Securities, Inc. Mr. Spann summarized Mr. Lovelady's findings and sent a memorandum, dated January 28, 1999, to Mr. Nevins. On February 1, 1999, Mr. Lovelady's detailed memorandum, concluding that it was possible Franklin American Life Insurance Company had been looted of its investments, was received by the Division of Insurance. Mr. Spann stated that he forwarded Mr. Lovelady's memorandum to Mr. Hosea, Mr. Nevins, and the Commissioner, that same day.

#### Lack of Communication of Available Information

Although Mr. Hosea and Mr. Nevins are uncertain as to the details known to them at the time and the then Commissioner does not recall ever receiving the information, it is clear that the information regarding the brokerage firm was available to these department staff and officials. It is also clear that Mr. Lovelady's findings were not discussed with the then Commissioner or Mr. Rob Moore, Chief Counsel of Insurance, before or during the February 2, 1999, meeting with Franklin American Life Insurance Company to determine whether to allow the company to reconvene its trading without a proper custodial agreement in place. The failure of department staff and officials to obtain a prudent understanding of the issue and the failure of division staff to apprise department officials of this critical information resulted in extending the period that Mr. Frankel's scheme went undetected.

#### Warning Signs

In December 1998, the department requested that Franklin American Life Insurance Company officials move the cash or securities supposedly held by Liberty National Securities, Inc., to a banking institution because the trading of securities, as reported by the company, had become less frequent and because of the growing concerns over the lack of the proper holding of these securities with the brokerage firm. According to a memorandum from Mr. Lovelady to the department, on December 28, 1998, the company agreed with the request and transferred approximately \$69 million in cash to an account with Prudential Savings Bank in Atlanta, Georgia. A custody agreement between Franklin American Life Insurance Company and Prudential Savings Bank was also being negotiated at that time.

#### Movement of Company Funds and Lack of Custodial Agreement

Without a proper custodial agreement in place with a banking institution, Franklin American Life Insurance Company was in violation of the *Rules of Department of Insurance* if the securities it purchased were held by a brokerage firm. From the acquisition of the insurance company by Thunor Trust in 1991, the company had allegedly traded through Liberty National Securities, Inc. Once the securities were allegedly liquidated and the cash deposited with Prudential Savings Bank in the first week of January 1999, the company initially purchased government securities through the bank, although a proper custodial agreement was not effected. However, under this arrangement, the company could not take advantage of the purported profits from

discounts allegedly available to them through trading performed by Liberty National Securities, Inc.

According to account statements from the bank, Franklin American Life Insurance Company officials transferred approximately \$69 million out of this account on January 12, 1999. The department was not made aware of this transfer until March 1999, when Mr. Lovelady reviewed the company's account statements from Liberty National Securities, Inc., for January 1999. The money was transferred back to the brokerage firm, allegedly to facilitate more trading. Had department officials already known that the money had been removed from the Prudential Savings Bank and placed with Liberty National Securities, Inc., they would not have agreed to the additional 60 days. The department relied upon the good faith of the company's representatives, who implied that the money was still with Prudential Savings Bank.

#### Company Sends Representatives to Promote Its Needs

During the later part of January 1999, Mr. Harlan Mathews, representing Franklin American Life Insurance Company, had several conversations with department officials relating to the company's need to continue its trading of governmental securities and the department's concerns over the lack of a proper custody agreement. At that time, the custody agreement between Franklin American Life Insurance Company and Prudential Savings Bank was being negotiated with the oversight of Mr. Lovelady. He was involved in reviewing the agreement and informing company officials of the inadequacies determined from his review. From State Audit's review of this matter, a proper agreement between the company and the bank was never finalized.

Two other individuals representing Franklin American Life Insurance Company also met with department officials in January 1999: Mr. Tom Quinn, an attorney with America Annuity and Life Acquisition; and Mr. Larry Martin, an attorney from New York. State auditors' efforts to contact Mr. Quinn were exhausted. Mr. Martin's attorney was contacted and declined an interview with state auditors.

#### Contract Examiner Obtains Information From Securities Division

On January 27, 1999, Mr. Lovelady met with Mr. Larry Burton, Chief of Broker-Dealer Registration in the Securities Division of the Tennessee Department of Commerce and Insurance. This meeting was called by Mr. Lovelady because requested documentation relating to the broker was not provided to Mr. Lovelady by representatives of Franklin American Life Insurance Company. Mr. Lovelady determined that Liberty National Securities, Inc., was registered as a broker-dealer with the state. However, he also determined that the brokerage firm's net worth was less than \$60,000, according to the firm's audited financial statements on file with the securities division, and therefore the company did not appear to have sufficient capital to be responsible for holding client securities (the firm allegedly held \$69 million in Franklin American Life Insurance Company's securities). In other words, if Franklin American Life Insurance Company's funds entrusted with the brokerage firm were misappropriated

by an agent or officer of the brokerage firm, the firm's minimal net worth would not cover such a loss. Nor would one expect that such a small firm would have an appropriate fidelity bond to cover such a loss. Furthermore, entrusting \$69 million with such a small firm was questionable.

Mr. Lovelady also noted that the brokerage firm had not reported that it was trading in government securities, which was inconsistent with the information he obtained from the insurance company. This inadequate disclosure raised questions with Mr. Lovelady as to whether this discrepancy was an indication of an oversight on the part of the brokerage firm or an indication of something more serious. The audited financial statements of the brokerage firm for the year ended December 31, 1997, filed with the securities division, made no mention of the brokerage firm's clients' cash or securities being held by the broker. In checking with the securities division, Mr. Lovelady discovered that Ms. Karen Timmins, the alleged Vice President of Liberty National Securities, Inc., and signer of the confirmation sent as part of the 1997 examination (see Exhibit G), was not a registered broker for the brokerage firm. Furthermore, the broker-dealer (BD) form filed with the department did not disclose a New York City address as stated on the confirmation returned by Ms. Timmins.

#### First Notification to Department Officials

On January 28, 1999, Mr. Spann wrote a memorandum to Mr. Nevins regarding Mr. Lovelady's contact with the securities division. In this memorandum, Mr. Spann did not detail Mr. Lovelady's findings and conclusions but recommended that the department advise Franklin American Life Insurance Company's officials to immediately stop the trading of government securities through Liberty National Securities, Inc. The memorandum also states that, in regard to the brokerage firm's apparent lack of sufficient capital, Mr. Hosea had contacted Mr. Harlan Mathews.

#### Financial Affairs Director's Interaction With Company Representative

According to Mr. Hosea, he spoke with Mr. Mathews on January 28, 1999. Mr. Hosea stated that he advised Mr. Mathews that the department had not decided whether to allow Franklin American Life Insurance Company to resume trading through Liberty National Securities, Inc., but at the moment it did not look promising. Mr. Hosea stated that he informed Mr. Mathews about the brokerage firm's lack of sufficient capital and their total annual revenues of only \$40,000. Mr. Hosea also informed Mr. Mathews that the prior transactions between Liberty National Securities, Inc., and Franklin American Life Insurance Company appeared to be those of affiliated entities rather than separate entities. According to Mr. Hosea, Mr. Mathews' response was that he had no knowledge that the two entities were affiliated.

#### Contract Examiner's Meeting With Company President

With questions regarding this information on the brokerage firm, Mr. Lovelady visited Franklin American Life Insurance Company on January 29, 1999, and spoke with Mr. Hackney. According to Mr. Lovelady's subsequent memorandum on this visit, Mr.

Hackney told him that the insurance company used the services of Liberty National Securities, Inc., because he and Mr. Eric Jensen, of Liberty National Securities, Inc., had participated in several banking deals in 1991. Mr. Lovelady's memorandum stated that Mr. Hackney's contacts within the brokerage firm were Mr. Dave Rosse and Ms. Karen Timmins. This memorandum also stated that Ms. Timmins was the individual that Mr. Hackney called to place his orders for security trades. Mr. Hackney told Mr. Lovelady that the brokerage firm had significant insurance coverage that would, in essence, compensate for the paucity in the firm's net worth in regard to any liabilities associated with the holding of its client's securities.

#### Second Notification to Department Officials--Contract Examiner's Memorandum

According to Mr. Lovelady, after receiving answers that were not responsive to his questions, he wrote a memorandum to Mr. Spann, dated February 1, 1999. In this memorandum, he stated,

There is a possibility that the company has been looted of its assets. It is possible that Liberty National Securities, Inc., may be a front for the interests that created Thunor Trust. If so, this would explain the original backers' agreements to a sole irrevocable trustee. (All funds provided would pass through the Trust, but would be returned to their control at the broker level. They would gain control of their original contributions, plus the other reserve assets.)

In other words, if the brokerage firm was just a front used to satisfy regulators that the funds were placed with a business to be invested, it was possible that the funds allegedly with that brokerage firm had actually been misappropriated. Furthermore, this possibility would explain the 1991 unusual irrevocable trust agreement of Thunor Trust, which placed the control of Franklin American Life Insurance Company with the sole trustee. If a fraudulent scheme to misappropriate funds was taking place involving the brokerage firm and the trustee, as is apparent now, under the trust agreement, the original funds used to purchase the controlling shares of Franklin American Life Insurance Company and its holding company could be returned to the brokerage firm along with all the reserves of the company.

According to Mr. Spann, he sent copies of Mr. Lovelady's February 1, 1999, memorandum to Mr. Hosea, Mr. Nevins, and Commissioner Sizemore on February 1, 1999. According to Mr. Spann, he wrote the notations at the top of this memorandum indicating his dissemination of the document. Mr. Hosea and Mr. Nevins stated that they recalled receiving the memorandum prior to the 60-day decision made on February 2, 1999.

#### Meeting to Discuss Allowing Company a Variance in Department Rules

On February 2, 1999, Mr. Sizemore, Mr. Moore, Mr. Hosea, Mr. Nevins, and Mr. Mathews met to discuss whether to give the company an additional 60 days to trade. The

concerns about the brokerage firm and the possible “looting” of insurance company assets were not discussed.

#### Decision to Allow Company an Additional 60 Days to Comply With Department Rules

The 60-day decision was made by Mr. Sizemore, then Commissioner, after it was recommended by Mr. Rob Moore, Chief Counsel for the Insurance Division. The actual letter to the company extending these additional trading days was signed by Mr. Nevins, Assistant Commissioner, on February 8, 1999. Although it is inconceivable that such treatment would be permitted under the circumstances, both the Commissioner and the chief counsel were apparently not aware of Mr. Lovelady’s February 1, 1999, letter or its contents, although the information was available to them.

#### Assistant Commissioner’s Statements Regarding Decision

According to Mr. Nevins, he may not have received the memorandum and read its contents before meeting with the Commissioner and chief counsel to discuss the matter. Mr. Nevins stated that he did not specifically recall ever reading Mr. Lovelady’s conclusion that the insurance company’s assets had possibly been “looted.” However, Mr. Nevins stated that he was aware of the brokerage firm’s lack of sufficient capital and that their annual revenues totaled only \$40,000. Mr. Nevins said that he did not consider this information as critical, and therefore Mr. Nevins did not even mention the subject during meetings prior to the February 2, 1999, decision. Mr. Nevins stated that the company had proven that the money existed when it was deposited in the Prudential Savings Bank, and the issue at that time was the custodial agreement and the treatment of the company’s assets in the department’s examination report for the five-year period ended December 31, 1997. In addition, Mr. Nevins stated that he was not aware that Franklin American Life Insurance Company officials had removed the cash from Prudential Savings Bank and moved it back to Liberty National Securities, Inc.

Mr. Nevins also stated that the issues discussed in the February 2, 1999, meeting included the custodial agreement, the Mississippi examination, and the possibility that the company would move its operations to Mississippi because that state’s statutes did not require insurance companies to have a custodial agreement with a banking institution.

#### Financial Affairs Director’s Statements Regarding Decision

According to Mr. Hosea, he did not specifically recall when he became aware of the issues addressed in Mr. Lovelady’s February 1, 1999, memorandum. However, he stated that he was not in favor of extending the company’s trading period without an approved custodial agreement. Mr. Hosea stated that he probably knew about the concerns Mr. Lovelady had, but he did not recall that these concerns were discussed in the February 2, 1999, meeting. He stated that he did not regard the problems with the brokerage firm as a possible fraud and therefore did not bring them up during the meeting. He stated that the department had allowed the company to trade without the required agreement for so long that Mr. Sizemore and Mr. Moore decided to allow them

60 additional days before the money would have to be deposited in a bank with a proper custodial agreement in place. Mr. Hosea stated that although he was against allowing the company additional days to trade its securities without a proper custodial agreement in place, the fact that the company produced the money and deposited it in a bank satisfied his concerns that the brokerage firm had not “looted” the company of its investments. Furthermore, Mr. Hosea stated that he was not aware that Franklin American Life Insurance Company officials had removed the cash from Prudential Savings Bank and moved it back to Liberty National Securities, Inc.

#### Additional 60 Days Approved

As a result of this meeting and the former Commissioner’s approval, Mr. Nevins sent Mr. Hackney a letter dated February 8, 1999, granting the additional time for which the company would be allowed to trade its investment portfolio. The letter also stated that during this 60-day period, the insurance division would study the various proposals submitted on behalf of the company by Mr. Mathews and Mr. Tom Quinn of American Annuity and Life Acquisition, which would remedy the issue of noncompliance with the regulations regarding the holding of securities. The various proposals submitted by Mr. Hackney included (1) the Commissioner authorizing insurance companies to hold their securities in street name with a broker; (2) a revision to the department’s rule authorizing this activity; (3) the Commissioner approving the company to utilize an affiliate company as an acceptable custodian; and (4) the possible relocation of the company to a state that allows securities of insurance companies to be held in street name with a broker.

### Chief Counsel's Statements Regarding Decision

Mr. Moore was interviewed on January 12, 2000, by staff of the Division of State Audit. Mr. Moore stated that no concerns about the brokerage firm's legitimacy were brought to his attention before he recommended the extension of 60 days. He stated that sometime after this February 8, 1999, decision, he became aware of the insurance division's concerns regarding Liberty National Securities, Inc., and its relationship with Franklin American Life Insurance Company. He stated that had he known about the concerns in Mr. Lovelady's February 1, 1999, memorandum, he would not have recommended a 60-day study period. Mr. Moore stated that he was not aware that Franklin American Life Insurance Company's entire investment portfolio was invested with Liberty National Securities, Inc. He said that if he had known the entire facts and the contents of Mr. Lovelady's February 1, 1999, memorandum, he would have recommended an investigation into Liberty National Securities, Inc., and recommended that the company keep its money in a bank. In addition, Mr. Moore stated that he was not aware that Franklin American Life Insurance Company officials had removed the cash from Prudential Savings Bank and moved it back to Liberty National Securities, Inc.

### Former Commissioner's Statements Regarding Decision

In an interview with state auditors on February 16, 2000, Mr. Sizemore stated that he recalled a meeting around the first of February 1999, which was attended by Mr. Moore, Mr. Nevins, Mr. Hosea, and Mr. Mathews. Mr. Sizemore stated that Mr. Mathews was urging them to allow for an additional trading period based on the department's failure to require the company to have a custodial arrangement in the prior seven years. According to Mr. Sizemore, the discussions centered around whether the assets of Franklin American Life Insurance Company for the year ended December 31, 1997, would be admitted in the examination report. According to Mr. Sizemore, Mr. Mathews wanted the department to extend the examination through December 31, 1998, and have the assets admitted since they were deposited with a bank on that date. Mr. Sizemore stated that he did not recall any discussion about the division's concerns about Liberty National Securities, Inc.

In regard to Mr. Lovelady's February 1, 1999, memorandum, Mr. Sizemore stated that he did not recall reading it but stated that some of the memorandum appeared familiar. However, he stated that he was not aware of the problems involving Liberty National Securities, Inc., and stated that had he known, he would not have allowed the company any additional time to trade its securities without a proper custodial agreement. Mr. Sizemore stated that he held a high opinion of Mr. Mathews and admitted that Mr. Mathews did influence his 60-day decision to some extent. He stated that he presumed that Mr. Mathews had looked into Franklin American Life Insurance Company and its relationship with Liberty National Securities, Inc., before he accepted the company as a client. Mr. Sizemore stated that he felt at ease knowing the respectability of Mr. Mathews. In addition, Mr. Sizemore stated that he was not aware that Franklin American Life Insurance Company officials had removed the cash from Prudential Savings Bank and moved it back to Liberty National Securities, Inc.

## Company Representative's Statements Regarding Decision

Mr. Harlan Mathews was interviewed by state auditors on June 6, 2000. Mr. Mathews stated that sometime in December 1998, he was approached by Mr. Thurston Little, a lobbyist whom Mr. Mathews had known for several years. Mr. Mathews then met with Mr. Little; Mr. Larry Martin, a consultant for FAL and a managing partner with American Annuity and Life Acquisition, LLP; and Mr. Brad Dye, an attorney from Mississippi. Mr. Martin requested that Mr. Mathews represent Franklin American Life Insurance Company because the company was having difficulty in trading its securities, in light of the Department of Commerce and Insurance's current insurance examination, which noted that the company's securities were allegedly held by a brokerage firm without a proper custodial agreement in place. According to Mr. Mathews, he was asked to represent the company because of his knowledge of state activities. According to company representatives, Tennessee's rule appeared to be unduly restrictive compared to Mississippi's ruling, which allowed insurance companies' securities to be held by a broker in "street name." According to Mr. Mathews, before he accepted the engagement to represent the company, he called Mr. Bill Hosea and discussed the department's viewpoint on the matter.

According to Mr. Mathews, Mr. Hosea told him that the insurance examiner on site at Franklin American Life Insurance Company had informed the company representatives that they needed to secure their securities through the proper arrangements or else it would become a problem. Mr. Mathews said that Mr. Hosea told him they were pleased with the company as a whole but they had to comply with NAIC rules. Mr. Mathews stated he then requested a meeting with Commissioner Sizemore. This meeting took place in late January 1999, and Mr. Mathews stated that the Commissioner and most of his upper-level staff attended along with other representatives of Franklin American Life Insurance Company. Mr. Mathews stated that after discussing the company's securities and lack of a proper custodial agreement, Commissioner Sizemore stated that he wanted to discuss the issue with the appropriate officials from Mississippi before he considered allowing the company to trade as they had before. Mr. Mathews said that Commissioner Sizemore verbally told the representatives from Franklin American Life Insurance Company that they had up to another 60 days before they would have to be in compliance with the department's rules.

Mr. Mathews stated that at the conclusion of the meeting, Commissioner Sizemore put the responsibility on him and Mr. Tom Quinn, Attorney with American Annuity and Life Acquisition, LLP, to develop solutions to the company's custodial problem. Mr. Mathews stated that he and Mr. Quinn were in the process of developing procedures that would bring the company in compliance with the department's rules when he was informed that the company actually moved its investments out of the bank before the 60-day letter was released on February 8, 1999. Mr. Mathews stated that before that date he had not been aware that the company had moved its investments. In another meeting with the Commissioner, sometime in March 1999, the Commissioner was upset because the department had learned that the company was not dealing with the department in a "good faith effort," in light of its movement of its securities, and that the Commissioner was now considering whether to "nonadmit" the investments as assets in

the current examination report. According to Mr. Mathews, Commissioner Sizemore told him to get his client to deposit the \$60 million back into a bank. According to Mr. Mathews, at that time, the direction of his representation changed, in that he then worked on getting the investments admitted. He stated that he told all the company representatives that they should cooperate with the department and that the money should be deposited in the bank by the April 8, 1999, deadline. Mr. Mathews stated that his client complied with Commissioner Sizemore's request. Mr. Mathews stated that had it not been for Commissioner Sizemore's actions in getting the money deposited into the bank, the State of Tennessee would have likely fallen victim to Mr. Frankel's scheme.

**WEAKNESSES IN THE INTERNAL CONTROLS AND THE SUBSEQUENT ACTIONS TAKEN BY THE DEPARTMENT**

During this review, weaknesses in the internal controls in the regulation of insurance companies, mainly involving the insurance division, were noted and discussed with management of the department. Management of the department has responded to these noted weaknesses and has developed procedures to correct these deficiencies. The findings, recommendations, and management's comments are below.

**1. Examination procedures were not followed and additional procedures are needed**

**Finding**

During the insurance division's examination of Franklin American Life Insurance Company in 1993, the examiners did not properly follow examination procedures regarding the verification of securities. The *Financial Condition Examiners Handbook* requires examiners to determine whether a custodial or safekeeping agreement with a bank or trust company was in place regarding the securities of the insurance company under examination. State Audit's review of the regulation of Franklin American Life Insurance Company revealed that the examiners accepted confirmations from Liberty National Securities, Inc., regarding the insurance company's reserves allegedly invested at the brokerage firm. Although the examination work papers for 1993 were destroyed pursuant to department practice, it is clear that a custodial agreement was not in place, yet the lack of such an agreement was not mentioned in the examination report issued in 1993. In addition, the insurance division, at that time, did not have a procedure requiring a supervisory review of examination work papers. However, the division has since adopted the NAIC procedures, which include a supervisory review.

Furthermore, the examiners were not required by examination procedures to consult with the securities division regarding the status, viability, and registration of a brokerage firm allegedly trading the insurance company's investments.

The failure of the examiners to follow the established examination procedures and accepting confirmations from the brokerage firm resulted in extending the period that a

fraudulent scheme, involving the insurance company's securities, went undetected. Additionally, the destruction of work papers for troubled insurance companies prohibits their proper review at a subsequent date, as was the case with Franklin American Life Insurance Company.

### **Recommendation**

Policies and procedures relative to the requirements that assets be held in a custodial bank pursuant to a custodial agreement should be followed. Additional policies and procedures should be promulgated to address confirmations, documentation, and supervisory review and signoffs. If assets are held or traded by a securities brokerage firm, the status and viability of the firm should be confirmed with the Securities Division. In addition, the division of insurance should determine the appropriate retention period for examination working papers. If the examination addresses a troubled company, the working papers should not be discarded under any circumstances. The department should consider appropriate disciplinary actions relating to the apparent lack of due diligence on the part of the various department staff.

### **Management's Comment**

We concur. The Insurance Division has issued Policy Statement #1 with an effective date of March 8, 2000, clearly delineating the procedure for confirmation of securities to include written confirmation of the status of the custodian bank, documentation of the assets and where they are held, reporting to supervisory staff, and documentation of supervisory review. Additionally, procedures contained within the policy statement are enumerated for both examination and financial analysis to ensure that adequate scrutiny is given to investment activity. This policy was distributed to all examination and financial analysis staff and was implemented immediately upon issuance. On March 8, 2000, a memo was forwarded to the Chief of Fiscal Services from the Assistant Commissioner of Insurance requesting an amendment to Records Disposition Authority #2227 governing the destruction of examination workpapers. This memo requests that the amended Records Disposition Authority read as follows:

Workpapers will be maintained in the office for a minimum of five years until the release of the next examination; at which point workpapers may be maintained either in the agency or in the records management center for an additional five years. Once the next subsequent report is issued, workpapers may be destroyed by an approved method after authorized in writing by the Assistant Commissioner for Insurance. For those companies with ongoing regulatory compliance and/or financial problems, examination workpapers shall be retained until said company has cured its regulatory deficiency and has maintained substantial compliance for a period of at least five years.

As noted in the finding, part of the failure resulted from inadequate procedures which the department has addressed. As recommended, management is considering additional appropriate corrective actions within the Insurance Division to ensure compliance with established laws, rules, and policies.

Due to the implementation of these and other enhanced procedures, the department is in the process of determining whether additional resources will be necessary.

## **2. Desk examinations need improvement and additional procedures**

### **Finding**

In the desk examinations (analytical reviews) of annual and quarterly financial statements of Franklin American Life Insurance Company by the insurance division, the procedures did not require the analysts to consider asset turnover. The unusual volume of trading and reported 20 percent return on investments for 1993 by the company should have raised additional questions during the review by the analysts. This unusual volume of trading (high asset turnover) continued to be reported by the company through 1998. If reasonable and understandable answers are not obtained from company officials, such a situation should prompt the use of an expert or prompt a properly targeted examination. Additionally, questions on investments, securities, and trading strategies should prompt insurance division staff to consult with the securities division. Furthermore, financial analyst supervisors were not required to confirm critical checklist items with the supporting documentation. In the desk examinations of the annual financial statements of Franklin American Life Insurance Company, reviews by analysts were conducted incorrectly. These errors were not detected because checklist items regarding the company's control of their assets were not properly reviewed by supervisors.

The lack of appropriate procedures and the lack of due diligence on the part of the insurance division staff to understand the reported financial activities of Franklin American Life Insurance Company resulted in extending the period that a fraudulent scheme, involving the insurance company's securities, went undetected.

### **Recommendation**

To ensure that unusually high trading activities are properly noted and reviewed, ratio and benchmark indicators for asset turnover need to be developed. Additionally, critical checklist items should be specified. Financial analyst supervisors should be required to confirm these critical checklist items with supporting documentation and to signify their confirmations with signoffs and dates. All materials received from or sent to companies should be date-stamped. All reviewers should be required to initial and date their reviews. Furthermore, the department should consider appropriate disciplinary actions relating to the lack of due diligence on the part of the various department staff.

## **Management's Comment**

We concur. A memorandum dated March 8, 2000, was issued by the Assistant Commissioner for Insurance to the Director of Financial Analysis, the Chief Examiner, and the Chief Analyst addressing items deemed critical and requiring enhanced, documented supervisory review. The following items were stipulated as requiring extensive supervisory review:

- Capital and Surplus – Ascertain that capital and/or surplus meet statutory requirements.
- Net Income/Losses – Review net income/loss for the current year as well as the preceding two years to ascertain whether a trend of declining profitability and potential net worth impairment appears imminent.
- General Interrogatories – Review all general interrogatories included in the review checklist to ensure that information on the checklist has been recorded correctly and poses no indication of noncompliance with state law. These interrogatories include, but are not limited to, questions regarding the custody of investments, changes in the corporate charter, by-laws, or articles of the corporation, conflicts of interest of corporate officials, reinsurance contracts, and contingent liabilities.
- Computed Ratios on Asset Turnover and Liquidity – Ratios are to be recomputed in accordance with the formula included in the checklist to determine whether the ratios are in excess of the established benchmarks. Asset turnover should be no more than one time per year and liquidity should range between 1:1 and 1:1.5.
- Actuarial Opinion – The checklist is to be compared to the actuarial opinion to ensure that the checklist is completed properly and that deficiencies in the opinion have been identified. Particular attention is to be given to questions relevant to the qualifications of the actuary, opinion elements, the actuary's expression of opinion, and concerns that may be expressed regarding surplus relief insurance.

To ensure that this enhanced review is adequately documented, the annual statement review checklists for life and health companies and property and casualty companies were revised and implemented in the review of the 1999 annual statements for all Tennessee domestic companies. Additionally, a form was developed and implemented to document the deficiencies noted in the review by the supervisor and the corrective actions taken by the analyst performing the review on said deficiencies.

It is the practice of the Insurance Division to date stamp all materials received within the division; however, to ensure that this procedure was adequately

communicated, a memorandum dated March 8, 2000, was distributed to all divisional staff emphasizing the importance of date stamping documents.

As noted in the finding, part of the failure resulted from inadequate procedures which the department has addressed. As recommended, management is considering additional appropriate corrective actions within the Insurance Division to ensure compliance with established laws, rules, and policies.

Due to the implementation of these and other enhanced procedures, the department is in the process of determining whether additional resources will be necessary.

### **3. “Target examination” procedures were not followed**

#### **Finding**

The insurance division did not document the work it performed in regard to the 1996 target examination of Franklin American Life Insurance Company as required by the *NAIC Examiners Handbook*. After a one-day on-site review of a limited number of trading confirmations and monthly statements from the brokerage firm allegedly investing the company’s funds, two analysts reported their inconclusive findings verbally to the insurance division director. No documentation was found in regard to the target examination. The *NAIC Examiners Handbook* states that such reports should describe, at a minimum, the limited objective of the examination, the overall scope of procedures applied, and the examiner’s findings from performing those procedures. Additionally, management of the insurance division failed to ensure that target examination procedures were followed.

Furthermore, after the analysts failed to obtain answers regarding the unusual trading strategy during the target examination, they recommended that the insurance division management hire a securities expert to pursue these outstanding issues. However, the insurance division management did not consult with the other divisions of the department and waited nearly two years before an expert was hired. The insurance division management’s inaction resulted in extending the period that a fraudulent scheme, involving the insurance company’s securities, went undetected.

#### **Recommendation**

Target examinations should be documented to include planning, objectives, scope, findings, and conclusions. Supervisory review of target examinations should also be documented by signoffs and dates. All meetings, telephone calls, letters, and e-mails with companies should be documented, and these communications should be maintained in insurance company files.

In addition, insurance division staff should consider attending training in regard to securities and investments. Furthermore, the department should consider appropriate disciplinary actions relating to the inactions and the apparent lack of due diligence on the part of the various department staff.

Moreover, the division of insurance should develop policies and procedures requiring staff to promptly notify top management, the department's legal section, and other divisions regarding any indications of fraud, abuse, or illegal acts.

### **Management's Comment**

We concur. In accordance with state law governing examinations of insurance companies, Policy Statement #3 was issued with an immediate effective date to the Chief Examiner by the Assistant Commissioner for Insurance on March 8, 2000, stipulating the procedures for the performance and documentation of target examinations. The procedures delineated within this policy state:

1. Once information has been received that necessitates a target examination by the division, a Certificate of Authority should be prepared by the Chief Counsel for Insurance for the Commissioner's signature. This Certificate of Authority should include information regarding the purpose and scope of the examination. If the purpose is a potential or actual violation of state law, the purpose should be documented with a statutory reference. The period reviewed, the personnel assigned and the date of the examination commencement should also be included as required information in the Certificate of Authority.
2. Once the target examination has begun, periodic written updates must be received from the on-site examiner. These updates may be as frequent as required by the Chief Examiner based on the facts ascertained by the on-site examiner.
3. Once the examination is completed, an examination report must be prepared by the on-site examiner and submitted to the Chief Examiner for review. After review, the Chief Examiner must submit to the Director of Financial Analysis, the Assistant Commissioner for Insurance, and the Chief Counsel for Insurance for additional review and approval for finalization.
4. If the on-site examiner discovers any indication of fraud, abuse, or illegal acts at any time during the target examination, said information must be immediately reported, in writing, to the Chief Examiner. Once received by the Chief Examiner, the report shall be immediately submitted to the Director of Financial Analysis, the Assistant Commissioner for Insurance, the Chief Counsel for Insurance, and the Commissioner for the Department of Commerce and Insurance. This submission should be clearly designated as high priority and measures must be taken to ensure that the information is communicated to the aforementioned departmental officials.

5. This policy is in effect until amended or rescinded by the Assistant Commissioner for Insurance.

Additionally, the Office of Audit and Consulting Services has consulted with the Examinations Section and has assisted in developing an appropriate reporting format for target examinations including planning, objectives, scope, findings, and conclusions.

To aid the department in its ability to employ experienced contract examiners to conduct both target and routine examinations, legislation was proposed by the department and passed during the most recent legislative session to increase the compensation paid to contract examiners. Public Chapter 642, effective April 10, 2000, will facilitate the department in employing examiners with specialized knowledge when particularly complex issues arise during an examination or when target examinations are needed to address problems arising prior to an insurer's routine examination.

Policy Statement #4 was issued to all Examinations Section Staff on March 8, 2000, from the Assistant Commissioner for Insurance. This policy addresses the documentation of and procedures for reporting indications of fraud, abuse, or illegal acts by an insurer. The policy further defines fraud, abuse, and illegal acts and clearly stipulates that any indication of these occurrences is to be reported to the Chief Examiner, the Director of Financial Analysis, the Assistant Commissioner for Insurance, the Chief Counsel for the Insurance Division, and the Commissioner for the Department of Commerce and Insurance. Although the guidelines in the NAIC Financial Examiner's Handbook remain silent in addressing fraudulent activity by an insurer, information compiled by the department's Office of Audit and Consulting Services regarding potential indicators of fraud was distributed to the Chief Examiner on April 14, 2000, for distribution to all Examination Section Staff as a guideline for use in field examinations.

Part of the department's failure resulted from a misinterpretation regarding appropriate target examination procedures. The department is clarifying and correcting this interpretation. As recommended, management is also considering additional appropriate corrective actions within the Insurance Division to ensure compliance with established laws, rules, and policies.

Due to the implementation of these and other enhanced procedures, the department is in the process of determining whether additional resources will be necessary.

#### **4. Documentation department-wide needs improvement**

##### **Finding**

The Insurance and Legal division reviews of acquisition and merger forms for Franklin American Life Insurance Company were not maintained in the insurance company files if they were documented originally in 1991. Additionally, documentation

of meetings, telephone calls, and other correspondence between department and company officials was not maintained. Furthermore, the decision to place Franklin American Life Insurance Company in administrative supervision was not documented in the insurance company files. The lack of documentation of reviews, communications, and decisions limits management's ability to support their actions and their ability to perform subsequent reviews related to these events.

### **Recommendation**

Insurance and Legal Division reviews of acquisition and merger forms should be documented and maintained in insurance company files. All meetings, telephone calls, letters, and e-mails with companies should be documented, and these communications should be maintained in insurance company files.

Furthermore, decisions regarding sanctions against insurers and any subsequent removals of sanctions should be documented and maintained in insurance company files.

### **Management's Comment**

We concur. On March 8, 2000, Policy Statement #5 was issued to address the appropriate procedures for maintaining documentation and approval of mergers. The primary purpose of this policy is to ensure that all documentation associated with a merger or acquisition affecting a Tennessee domiciled insurer is properly reviewed, transmitted, and approved in accordance with state law and departmental rules and regulations. The policy procedures clearly delineate the process for review, the documentation required, and the levels of review required. All information is to be maintained in the individual insurance company file. Policy Statement #2 addressing the documentation of meetings with insurance companies and the retention of meeting documentation was issued with an effective date of March 8, 2000, and requires that notes of the meeting activities be taken, transcribed, and maintained in the company's file. Additionally, Policy Statement #6 was issued on March 8, 2000, setting forth the appropriate procedures for documenting regulatory actions taken against an insurer.

Due to the implementation of these and other enhanced procedures, the department is in the process of determining whether additional resources will be necessary.

Exhibit A

Custodian Affidavit forms were sent to Liberty National Securities, Inc., as part of the 1992 examinations to verify if Franklin American Life Insurance Company's funds were invested with the brokerage firm. From presently available information, it appears that Mr. Frankel actually signed or had the form signed by someone other than Mr. William Kok (1). The forms were altered to replace the words "bank" with the words "brokerage firm" (2). The insurance examiners accepted these forms without question and no supervisory review was performed.

FORM A  
CUSTODIAN AFFIDAVIT

(For use by a custodian bank for securities entrusted to its care which have not been re-deposited elsewhere.)

mg 10/14

STATE OF Ohio )  
COUNTY OF Lucas ) SS:

I, William Kok, being duly sworn deposes and says that he is President of Liberty National Securities, Inc. a banking corporation organized under and pursuant to the laws of the State of Ohio with the principal place of business at Sylvania, Ohio (hereinafter called the "bank");

2

That his duties involve supervision of activities of the bank as custodian and records relating thereto;

That the bank is custodian for certain securities of Franklin American Life Insurance Co. having a place of business at 377 Riverside Dr., Franklin (hereinafter called the "insurance company") pursuant to an agreement between the bank and the insurance company;

2

That the schedule attached hereto is a true and complete statement of securities (other than those caused to be deposited with the Depository Trust Company or like entity or a Federal Reserve bank under the Federal Reserve book entry procedure) which were in the custody of the bank for the account of the insurance company as of the close of business on 7/13/93; that, unless otherwise indicated on the schedule, the next maturing and all subsequent coupons were then either attached to coupon bonds or in the process of collection; and that, unless otherwise shown on the schedule, all such securities were in bearer form or in registered form in the name of the insurance company or its nominee or a nominee of the bank, or were in the process of being registered in such form;

That the bank as custodian has the responsibility for the safekeeping of such securities as that responsibility is specifically set forth in the agreement between the bank as custodian and the insurance company; and

That, to the best of his knowledge and belief, unless otherwise shown on the schedule, said securities were the property of said insurance company and were free of all liens, claims or encumbrances whatsoever.

Insurance 004705

2

Subscribed and sworn to before me this 13th day of July, 1993

1

William Kok (L.S.)  
Vice President or other authorized officer

\* Whenever the words "bank" or "banking corporation" appear in this document, please substitute "examined brokerage firm"

**Exhibit B**

(1) Franklin American Life Insurance Company officials submitted general interrogatories to the department as part of their unaudited 1993 annual financial statements. Franklin American Life Insurance Company stated that they maintained exclusive control of their securities, when in fact, the company's investment funds had been placed with Liberty National Securities, Inc. This brokerage firm was apparently controlled by Mr. Martin Frankel.

ANNUAL STATEMENT FOR THE YEAR 1993 OF THE FRANKLIN AMERICAN LIFE INSURANCE COMPANY

**GENERAL INTERROGATORIES**

1. In all cases where the company has assumed liabilities and has to make any further payments, provision should be made in this statement on account of such contingencies for a period equal to that which the original contract will have been required to establish had it retained the rights. Has this been done?  Yes  No

2. Is the business of the company conducted under the actual, direct or indirect proprietorship of:  
 Name:  Individual  Partnership  Solely Proprietary

3. Is the company a member of an insurance holding company system consisting of two or more affiliated persons, one or more of which is an insurer?  Yes  No

4. (a) If the return to Commissioner's Interrogatory 2 is yes, did the company register and file with the Department of Insurance, Insurance Guaranty or Surety Fund, or with the regulatory official of the state of domicile of the principal office of the holding company system, a registration statement providing disclosure substantially similar to the disclosure required by the National Association of Insurance Commissioners in its form Insurance Holding Company System Regulatory Act and such regulations promulgated thereunder, or in the return subject to statement and such other requirements substantially similar to those required by such act and regulations?  Yes  No  
 (b) Filing Date: \_\_\_\_\_

5. (a) Has the company borrowed federal income tax or state income tax from the government of the United States?  
 (b) If yes, Percentage of foreign monthly premium or interest: \_\_\_\_\_  
 Type of interest: \_\_\_\_\_

6. (a) Has the company borrowed federal income tax or state income tax, through a holding company system, from the government of the United States?  
 (b) If yes, Percentage of foreign monthly premium or interest: \_\_\_\_\_  
 Type of interest: \_\_\_\_\_

7. (a) HAS THE COMPANY BEEN IN RECEIPT OF ANY FEDERAL GOVERNMENT GRANTS OR ASSISTANCE IN THE FORM OF FEDERAL FUNDS?  
 (b) If yes, Total federal grant received during the year: \_\_\_\_\_  
 (c) Name of grant: \_\_\_\_\_  
 (d) Date: \_\_\_\_\_

8. (a) Has the company received any federal income tax or state income tax from the government of the United States?  
 (b) If yes, Percentage of foreign monthly premium or interest: \_\_\_\_\_  
 Type of interest: \_\_\_\_\_

9. (a) Has the company received any federal income tax or state income tax from the government of the United States?  
 (b) If yes, Percentage of foreign monthly premium or interest: \_\_\_\_\_  
 Type of interest: \_\_\_\_\_

10. (a) Has the company received any federal income tax or state income tax from the government of the United States?  
 (b) If yes, Percentage of foreign monthly premium or interest: \_\_\_\_\_  
 Type of interest: \_\_\_\_\_

11. CAPITAL STOCK OF THIS COMPANY

Class	Number Shares Authorized	Number Shares Outstanding	Par Value Per Share	Dividends Paid or Set Aside	DIVIDENDS PAID		ANY DIVIDENDS DECLARED	
					1993	1992	1993	1992
Preferred								
Common	1,000,000	1,000,000	1.00	1111	111	111	111	

12. (a) Has the company any securities of a real estate holding company or otherwise held real estate interest?  
 (b) Name of real estate holding company: \_\_\_\_\_  
 (c) Nature of interest involved: \_\_\_\_\_  
 (d) Total book value: \_\_\_\_\_

13. (a) Has the company any securities of a real estate holding company or otherwise held real estate interest?  
 (b) Name of real estate holding company: \_\_\_\_\_  
 (c) Nature of interest involved: \_\_\_\_\_  
 (d) Total book value: \_\_\_\_\_

14. (a) Has the company any securities of a real estate holding company or otherwise held real estate interest?  
 (b) Name of real estate holding company: \_\_\_\_\_  
 (c) Nature of interest involved: \_\_\_\_\_  
 (d) Total book value: \_\_\_\_\_

15. (a) Has the company any securities of a real estate holding company or otherwise held real estate interest?  
 (b) Name of real estate holding company: \_\_\_\_\_  
 (c) Nature of interest involved: \_\_\_\_\_  
 (d) Total book value: \_\_\_\_\_

16. (a) Has the company any securities of a real estate holding company or otherwise held real estate interest?  
 (b) Name of real estate holding company: \_\_\_\_\_  
 (c) Nature of interest involved: \_\_\_\_\_  
 (d) Total book value: \_\_\_\_\_

17. (a) Has the company any securities of a real estate holding company or otherwise held real estate interest?  
 (b) Name of real estate holding company: \_\_\_\_\_  
 (c) Nature of interest involved: \_\_\_\_\_  
 (d) Total book value: \_\_\_\_\_

18. (a) Has the company any securities of a real estate holding company or otherwise held real estate interest?  
 (b) Name of real estate holding company: \_\_\_\_\_  
 (c) Nature of interest involved: \_\_\_\_\_  
 (d) Total book value: \_\_\_\_\_

19. (a) Were all the stocks, bonds and other securities owned December 31 of current year, over which the company has exclusive control, in the actual possession of the company on said date, except as shown by the Schedule of Special Deposits? Yes  No

(b) If no, give full and complete information relating thereto:

1

## Exhibit C

- (1) Franklin American Life Insurance Company officials submitted general interrogatories to the department as part of their unaudited 1994 annual financial statements. For the first time, company officials reported that the company's investment funds were not in exclusive control of the company but were held by "broker in street name." The interrogatories lacked reference to custodial agreements that are required when a company's invested funds are not in their exclusive control.

### GENERAL INTERROGATORIES

1. In all cases where the company has assumed accident and health risks from another company, provision should be made in this statement on account of such requirements for a reserve equal to that which the original company could have been required to establish had it retained the risks. Are there any such? Yes  No

2. In the business of the company conducted upon the mutual, mixed or strictly proprietary plan Yes  No

3. In the company a member of an insurance holding Company System consisting of two or more affiliated persons, one or more of which is an insurer? Yes  No

4. Tell if the name to General Interrogatory 3 is yes, did the company register and file with its domiciliary State Insurance Commissioner, Director or Superintendent, or with such regulatory official of the state of domicile of the principal insurer in the holding Company System, a registration statement governing its business substantially similar to the statement required by the National Association of Insurance Commissioners to its Model Insurance Holding Company System legislative act and state registration pertaining thereto, or is the company subject to standards and disclosure requirements substantially similar to those required by such act and regulations? Yes  No

5. Tell how any foreign domiciled State person or entity directly or indirectly own 10% or more of the company? Yes  No

6. Tell how any foreign domiciled State person or entity directly or indirectly through a holding company system control the company or bound by the state of domicile under its holding company act? Yes  No

7. Tell how any foreign domiciled State person or entity directly or indirectly through a holding company system control the company or bound by the state of domicile under its holding company act? Yes  No

8. Tell how any foreign domiciled State person or entity directly or indirectly through a holding company system control the company or bound by the state of domicile under its holding company act? Yes  No

9. Tell how any foreign domiciled State person or entity directly or indirectly through a holding company system control the company or bound by the state of domicile under its holding company act? Yes  No

10. Tell how any foreign domiciled State person or entity directly or indirectly through a holding company system control the company or bound by the state of domicile under its holding company act? Yes  No

11. Tell how any foreign domiciled State person or entity directly or indirectly through a holding company system control the company or bound by the state of domicile under its holding company act? Yes  No

12. Tell how any foreign domiciled State person or entity directly or indirectly through a holding company system control the company or bound by the state of domicile under its holding company act? Yes  No

13. Tell how any foreign domiciled State person or entity directly or indirectly through a holding company system control the company or bound by the state of domicile under its holding company act? Yes  No

14. Tell how any foreign domiciled State person or entity directly or indirectly through a holding company system control the company or bound by the state of domicile under its holding company act? Yes  No

15. Tell how any foreign domiciled State person or entity directly or indirectly through a holding company system control the company or bound by the state of domicile under its holding company act? Yes  No

16. Tell how any foreign domiciled State person or entity directly or indirectly through a holding company system control the company or bound by the state of domicile under its holding company act? Yes  No

17. Tell how any foreign domiciled State person or entity directly or indirectly through a holding company system control the company or bound by the state of domicile under its holding company act? Yes  No

18. Tell how any foreign domiciled State person or entity directly or indirectly through a holding company system control the company or bound by the state of domicile under its holding company act? Yes  No

19. (a) Were all the stocks, bonds and other securities owned December 31 of current year, over which the company has exclusive control, in the actual possession of the company on said date, except as shown by the Schedule of Special Deposits? Yes  No

(b) If no, give full and complete information relating thereto:  
HELD BY BROKER IN STREET NAME.....



## Exhibit D

(1) Analysts of the division of insurance use checklists during their desk examinations of unaudited annual financial statements submitted by insurance companies to document their review and findings. The analyst reviewing Franklin American Life Insurance Company's 1994 annual statement incorrectly indicated that the company had exclusive control of its assets when, in fact, the company had reported that its assets were held by broker in street name.

### TENNESSEE LIFE - PRELIMINARY AUDIT - 1994 ANNUAL STATEMENT

PG	SCH (S), EXH (E)	FINANCIAL DATA	12-31-94 ANNUAL STATEMENT	Yes	No
		LINE (L) or COL (C)			
4	L 43A+44A	-T- PAID IN	\$ <u>0</u>		
4	L 45	-U- DIVIDENDS PAID	is amount = > 10% Prior Yr. Cap. & Surp OR 100% Prior Yr. Net Gains from Operation.....		✓
		\$ _____	Give amount if above answer is YES		
4	L 46	-V- WRITE IN	=> 10% Cap. & Surp.....		✓
		\$ _____	Give amount if above answer is YES		
4	L 47	-W- NET CHANGE IN CAP. & SURP.	\$ <u>&lt;901,287&gt;</u> % Give amount & %		
		Is the percentage greater than 10% of Cap & Surp?.....			✓
5	L 20	-X- NET CASH FROM OPERATIONS	is a NEG. Amt. and > 3% of Cap. & Surp. ....		✓
		\$ _____	% Give amount & % if above answer is YES		
24	L 43 C 1	-Y- Is the Total Inv. in Parent, Subs & Affiliates	greater than 50% of Cap & Surp?.....		✓
		\$ _____	Give amount if above answer is YES and		
		IF YES is amount > Cap. & Surp less \$2M? IF YES HAND TO LIFE ANAL. ....			✓
28	L 1	-Z- If the Company assumed A&H Risks	have reserves been established?.....	✓	
28	L 3	-AA- Is Company a member of a HOLDING COMPANY?	.....	✓	
		(If yes XC: Holding Company ANAL. Mark yes when XC is done).....		✓	
28	L 13	-BB- Did any person while officer, director or trustee	of the Co. receive directly or indirectly, during the period covered by this statement, any commission on business transactions of the company?..(TCA 56-3-105 (b)(4)(c)).....		✓
28	L 19	-CC- Co holds assets NOT exclusively under the control	of the Company.....		✓
		\$ _____	Give amount if above answer is YES		
30	14	-DD- Does the Company have any contingent liabilities?	.....		✓
		\$ _____	Give amount if above answer is YES		
31	Various	-EE- SPECIAL DEPOSITS	The Company holds Securities in the 3 highest grades on Lines ZZ0001 thru ZZ9998 held in TN OR on Line TN0001 thru TN9998 =>\$200,000 (market value) in the 3 highest grades.....		✓
31	Various	-FF- SPECIAL DEPOSITS	The Company holds Securities in an individual state (Example Lines AL0001 thru WY9998) which is greater than the individual prems in Sch T Col 3+4+5+6 for that individual state.....	✓	1.
		IF YES GIVE DIFFERENCES BY STATE ON THE CONCLUSION PAGE.			
40	Sch B, Pt2, Sec2, C4	-GG- GRAND TOTAL MORTGAGE LOANS	over 90 days past due is positive.....		✓
		\$ _____	Give amount if above answer is YES		
41	Sch B, Pt2, Sec. 3, C4	-HH- GRAND TOTAL MORTGAGE LOANS	in foreclosure is positive.....		✓
		\$ _____	Give amount if above answer is YES		
40-41	Sch B., Pt 2 Sec 2 & 3	-II- The sum of Pg 40 Col 4 + Pg 41 Col 4	(Mortgage Loans) exceeds 3% of Mortgage Loans reported on Pg 2 Line 3.....		✓
		\$ _____	Give amount if above answer is YES		
56	Sch D, Pt 1, Sec 1, L7.4+ 7.5+7.6, C7	-JJ- NON INVESTMENT GRADE BONDS	exceeds the lesser of 10% of Assets excluding Separate Account Assets OR Cap & Surp less \$2M.....		✓
		\$ <u>0</u>	TOTAL NON-INVESTMENT GRADE BONDS		✓
83	Sch DM L 1 C 3	-KK- Are BONDS in excess of Statement	over Market (-)?.....		✓
		\$ _____	Give amount if above answer is YES		
83	Sch DM L 2 C 3	-LL- Are PREFERRED STOCKS in excess	of Statement over Market (-)?.....		✓
		\$ _____	Give amount if above answer is YES		
83	Sch DM L 3 C 3 and L 3 C 1	-MM- Is Col 3, line 3 negative and greater	than 10% of Statement Value L3 C1 or > 20% of Cap & Surp.....		✓
		\$ _____	Give amount if above answer is YES		



### Exhibit E

(I) Analysts of the division of insurance use checklists during their desk examinations of unaudited annual financial statements submitted by insurance companies to document their review and findings. The analyst reviewing Franklin American Life Insurance Company's 1995 annual statement incorrectly indicated that the company had exclusive control of its assets when, in fact, the company had reported that its assets were held by broker in street name. Although the analyst did not correctly answer the corresponding question on the checklist, the analyst did write in a comment that the assets were held by broker in street name. However, this was not noted during the supervisor's review of the checklist, and therefore no further review was performed.

**Tennessee Life & Accident - Preliminary Audit - 1995 Annual Statement**

		Yes	No
EXB(E)	<u>Financial Data</u> <u>12-31-1995 annual statement</u>		:
Line(L) Col(C)			:
L46	Is Write-In amount > 10% Cap & Surp \$ _____ Give amount if above answered yes	.	✓
L47 C1	Is the percent of Net Change in Cap & Surplus greater than 10% of total Cap & Surp? If yes give amounts and % below. \$ <u>3076.7%</u> <u>27.1 %</u>	20	.
L48	Is Net Cash From Operations a negative amt and > 3% Cap & Surp \$ <u>(1640371)</u> <u>157.2 %</u> give amount and % if answered yes.	30	.
L49 C1	Is the total Inv in Parent, Subs & Affil > 30% of Capital & Surplus \$ _____ Give amount if above answered yes.	.	✓
L1	If yes, is amount > Cap & Surp less S2M? If yes hand to life analyst. If the company assumed A&H risks, have reserves been established?	.	✓
L3	Is Company a member of a holding company? After completion of audit sheet forward to Holding Co Analyst. Holding Company Analyst to Initial here. <u>(K)</u>	.	✓
L15	Did any person while an officer, director or trustee of the Co receive directly or indirectly, during the period covered by this statement any Commission on business transactions of the Co? TCA 56-3-105(b)(4)(c)	.	✓
L19	Were all stocks, bonds, and other securities owned exclusively under the control of the Company? \$ <u>Held by broker</u> Give amount if above answered no.	✓	.
L19	If yes forward to Life Analyst.	.	✓
L14	Does the company have any contingent liabilities? \$ _____ Give amount if above answered yes.	.	✓
various	General and/or Special Deposits: The company holds securities rated 1 or 2 by the SVO grades on lines ZZ0001 thru ZZ9998 held in the state of domicile or TN or a special deposit in TN reported on lines TN0001 thru TN9998 => \$200,000 (mkt value) in the 2 highest grades.	.	✓
31 various	Special Deposits: The company holds securities in an individual state (Example is A10001 thru WY9998) which is greater than the individual premiums in SCH T Col 3+4+5+6 for that individual state. If yes give difference by state on the conclusion page.	40	.
40 Sch B Pt 2 Sec 2 C4	Grand total mortgage loans over 90 days past due is positive \$ _____ Give amount if above answered yes.	.	✓
41 Sch B Pt 2 Sec 3 C4	Grand total mortgage loans in foreclosure is positive. \$ _____ Give amount if above answered yes.	.	✓
42-43 Sch B Pt 2 Sec 2&3 C4	The sum of Pg 40 C4 + Pg 41 C4 (mortgage loans) exceeds 3% of mortgage loans reported on Pg 2 L3. \$ _____ Give amount if above answered yes.	.	✓

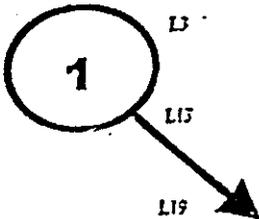


Exhibit F  
(Page 1 of 6)

According to a memorandum dated February 1, 1999, from Mr. Billy Lovelady, Examiner in Charge, to Mr. Don Spann, Chief Examiner, Mr. Lovelady stated (1) "there is a possibility that the company has been looted of its assets"; (2) Mr. Lovelady determined that the brokerage firm's net worth was less than \$60,000 and therefore it did not appear to have sufficient capital to be responsible for holding its client assets, let alone the alleged \$69 million in Franklin American Life Insurance Company's assets; and (3) according to Mr. Spann, copies of this memorandum were distributed to Mr. Bill Hosea, Director of the Division of Insurance; Mr. Neil Nevins, Assistant Commissioner of the Division of Insurance; and Commissioner Douglas Sizemore.

3

Copy to <sup>Conn.</sup> Neil & Bill

Confidential  
Examination  
Workpaper  
memo. *HW*

TENNESSEE DEPARTMENT OF COMMERCE AND INSURANCE  
EXAMINATION OF  
FRANKLIN AMERICAN LIFE INSURANCE COMPANY  
AS OF DECEMBER 31, 1997

MEMO: BWL-6

RECEIVED

TO: Don Spann, Chief Examiner  
FROM: Billy W. Lovelady, Examiner in Charge *per*  
DATE: February 1, 1999  
RE: Franklin American Life Insurance Company - Asset Verifications

FEB 01 1999  
Dept. of Commerce & Insurance  
EXAMINATION SECTION

I am falling badly behind on my estimated completion date. Procedures regarding asset verifications and holding company relationships have become much more complex than anticipated.

The Oklahoma Insurance Department issued a report on an affiliated insurer last year which admitted broker held bonds; the Mississippi Insurance Department just finished the examination of two other affiliated insurance companies, subject to review of the treatment of the broker held securities; and the Company's outside auditors have accepted confirmations from Liberty National Securities, Inc.

1

It has been my understanding that, if the Company moved the broker held bonds to a qualified custodian (Bank or Trust Company) before this examination was completed, the bank would be admitted in the 12/31/97 examination report. The Company sold the bonds on December 16, 1998 and moved the proceeds to Prudential Securities at 12/5/98 under a custodial agreement with Prudential Savings Bank. The Prudential Savings Bank custodial agreement still needs amendments to meet the requirements of the NAIC Examiner Handbook. However, I have proceeded on the basis that the amendments would be made before completion of the report, and that the 1998 receipt of the funds was a sufficient confirmation procedure to admit the bonds. I had planned a report comment on the non-acceptable holding practice and its subsequent correction.

The problem is that Liberty National Securities may be operating outside of its licensed authority and is not of sufficient financial standing that an examiner should place substantial reliance on its confirmation of assets held, especially when solvency of the insurer is dependent upon the validity of the confirmation.

There is a possibility that the Company has been looted of its assets. It is possible that Liberty National Securities, Inc. may be a front for the interests that created Thayer Trust. If so, this would explain the original backers' agreement to a sole irrevocable trustee. (All funds provided would pass through the Trust, but be returned to their control at the broker level. They would gain control of their original contributions, plus the other reserve assets.)

Such an operation could go undetected for years and could be repeated many times, so long as premiums continued to cover the current cash outflows and asset confirmations were accepted from the broker.

Insurance - 12993

Exhibit F  
(Page 2 of 6)

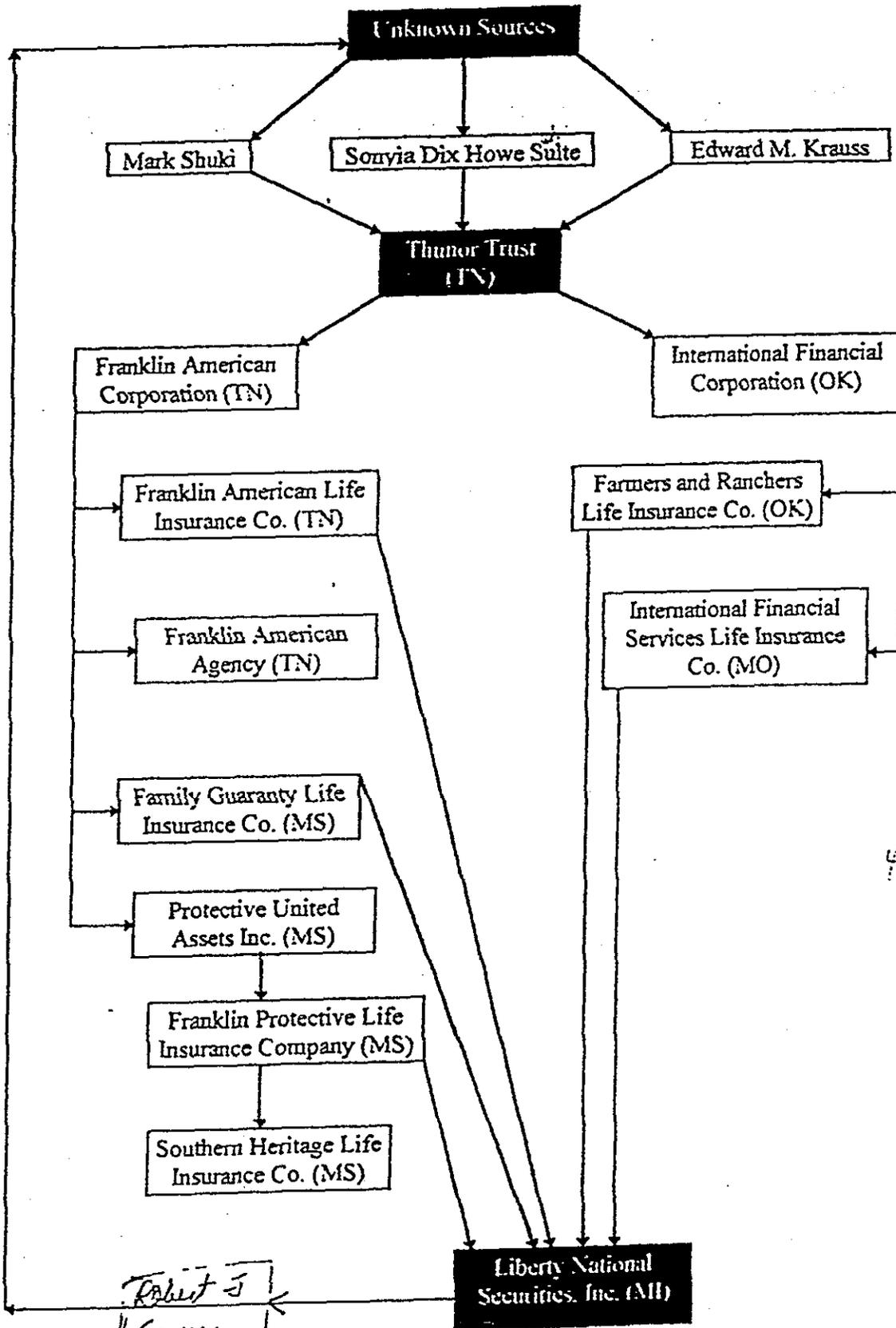
There are many scenarios that could be played out under these circumstances. If the ultimate recipient of the funds prospers sufficiently, the original funds plus historical earnings on the assets (never truly purchased) could be returned to the Company with no regulatory authority the wiser. If the situation bombs, the backers abscond with the remaining funds, which, in all likelihood, would still exceed the original contributions.

In any event, I simply cannot see the logic of (1) a trust agreement which gives one person absolute, irrevocable, and continuous control over millions of dollars with no contractual assurance that the funds will ever be returned to the grantors or beneficiaries; (2) the use of a small and little known brokerage firm for massive bond transactions; and (3) the expertise and/or secret process which permits the Company to consistently record exceptional gains on bond trades, but prevents the bonds from being held under a custodial arrangement with a bank or trust company.

I want to be sure to comply with the Department's standard audit procedures and reporting requirements. Therefore, I am requesting guidance on how to proceed under the circumstances. You and Bill Hosca may want to discuss this with Larry D. Burton, chief of broker dealer registration in the Securities Division. I believe that Franklin American Corporation may currently have other matters pending before that Division. In the mean time, I have sent another broker confirmation letter and also plan to contact the broker by phone.

I am attaching a diagram that reflects the holding company ownership pattern and the inflow of funds to Liberty National Securities, Inc. from the affiliated insurers. The indication of an outflow from Liberty National to unknown sources is, of course, unproved. I am also attaching notes of some considerations which have led me to these conclusions.

Exhibit F  
(Page 3 of 6)



4/2/99  
D

**Exhibit F**  
**(Page 4 of 6)**

**CONSIDERATIONS**

In late 1991, Thmor Trust and Franklin American Corporation were formed to refinance and take control of Franklin American Life Insurance Company. Liberty National Securities, Inc. was also licensed in Tennessee at approximately the same time. Mr. Hackney, the sole trustee of the Trust and the chief operating officer of all the affiliated companies, admits that the brokerage firm became licensed in Tennessee in order to handle Franklin American Life Insurance Company's investments.

The original Form A filing for the acquisition disclosed information only back to the Thmor Trust level. Significant items in the filing included the following:

- The trust was created by three grantors who each named an apparently related beneficiary. The original contributions approximated \$3,900,000, the bulk of which was passed through Franklin American Corporation to Franklin American Life Insurance Company. Each grantor signed an affidavit that none of the funds came from Eric C. Jensen, but did not specify any other source of the funds. The Form A filing does not disclose the reason that Mr. Jensen withdrew as a grantor nor why the affidavits were required. In a recent conversation with Mr. Hackney, the examiner inquired as to any other grantors in the Trust and if the participation percentages remained the same. The response was that there were no other grantors, but the participation percentages may not be the same.
- Because each of the grantors represents more than a 10% indirect control of Franklin American Life Insurance Company, further disclosure of each grantor's other holdings would appear proper. In the alternative, each grantor should have filed a disclaimer of control with the Tennessee Department of Commerce and Insurance.
- The Trust appointed Mr. John A. Hackney as the irrevocable sole trustee, so long as the trust owned any interest in Franklin American Corporation. Mr. Hackney reports no financial interest in the trust or any of the corporations within the holding company system. It is difficult to logically accept that three individuals would give a non-related party absolute control of \$3,900,000 (Around \$110,000,000 at 12/31/97) without a means forcing termination of the arrangement and a means of reclaiming the funds for the grantors or beneficiaries. Mr. Hackney appoints all directors and officers of all of the affiliated companies and makes all investment decisions, even down to calling in the bond trades to the broker.

Franklin American Life Insurance Company was examined in 1993 with a valuation date of December 31, 1992. The 1992 annual statement and examination confirm that Franklin American Life Insurance Company had already transferred most all of its assets to Liberty National Securities, Inc.

A financial statement of the Trust indicates that significant amounts (Approximately \$106,000,000) have come into the Trust since 1992 and that these funds have been used to acquire additional stock of Franklin American Corporation and other corporations. The acquisitions include insurers domiciled in at least three other states. In each case, the insurer's assets are sold and the proceeds are placed with Liberty National Securities.

Since 1992, the Form F filings and the annual statements of the insurers have been reported as if the two holding companies, Franklin American Corporation and International Financial Corporation were each separate ultimate controlling entities. Therefore, it does not appear that adequate disclosure has been made.

Exhibit F  
(Page 5 of 6)

In November 1998, Franklin American Life Insurance Company was told that unless it placed the broker held assets with a bank or trust company, the assets would be not admitted in the 12/31/97 examination report. The insurer reported all such securities as sold on 12/16/98 with the proceeds being wired to Franklin American Corporation's bank account. Franklin American Life Insurance Company's First Tennessee December bank statement reports the funds to be transferred between the two affiliates. Another wire transfer sent the funds to Prudential Securities for a mutual fund investment which was still held on 12/31/98. On January 25, 1999, consultants for Franklin American Life Insurance Company met with representatives from the Tennessee Department of Commerce and Insurance to request permission to return to its bond investment practices with Liberty National Securities, Inc.

The current examination has requested Company management to provide documentation relating to the broker (Dunn and Bradstreet reports, audited financial statements, etc.), but such documentation was not received from the Company. On January 27, 1999, the examiner met with agents from the Securities Division of the Tennessee Department of Commerce and Insurance [Larry D. Burton, chief of broker dealer registration, & Don Taylor, Examiner]. The following was developed from this meeting:

- An audited financial statement of Liberty National Securities Inc., as filed with the Department for the year ending 12/31/97, was obtained.
- The agents indicated some concerns regarding Liberty's registration filings because they had not report that they were trading in U.S. Government securities. They indicated that Liberty did not appear to be of sufficient capitalization to perform "back office functions" (hold clients' funds and/or securities). Also they indicated that there should be some mention in the financial statements about funds or securities held for clients. They also expressed concern that their records did not reflect the N.Y., N.Y. address shown on the broker's trade advices.
- The agents provided information that Robert James Guyer of Dundee, Ohio owns at least 75% and probably 100% of the stock of Liberty. Guyer appears to have begun control affiliation in April of 1993.
- The Divisions records did not reflect that Karen P. Timmins was a registered broker for Liberty National Securities, Inc.

2

A review of the audited financial statement of Liberty National Securities Inc. revealed the following:

- The statement was audited by Arthur Allen, CPA of Toledo, Ohio. The report disclosed that the broker was originally incorporated in Indiana on June 24, 1985 as Prime Securities, Inc. Its operations never reported a profit between 1985 and 1994. The 1997 audit reports another net loss.
- The Company only has a net worth of \$58,546.56.
- Total receipts for the year, \$43,337.80, included \$40,297.66 of earned commissions. It would appear that trades with members of the holding company system alone should approximate that amount.
- Although, the broker states that all of its trades are made through a clearing broker, J. W. Charles Clearing Corp., total commission expense reported was less than \$25,000.
- The report made no mention of cash, bonds or other securities being held by the broker at the valuation date.

**Exhibit F**  
**(Page 6 of 6)**

- Total fixed assets were reported at \$1,724.04 and would not appear to support a permanent office operation.

On the afternoon of January 29, 1999, the examiner met with Mr. Hackney. The following information was obtained:

- When asked how the insurance company came to use Liberty National Securities, Mr. Hackney stated that he knew Eric Jensen back in 1991, that they had done some deals (bought banks) together or were in the banking business together. (The Form A filing indicates Mr. Jensen was only 24 in 1991). When asked about Mr. Jensen being the originally proposed grantor to the Trust, Mr. Hackney said something to the effect that Mr. Jensen decided he would rather do the brokerage and not get into the insurance side. Mr. Hackney stated that he had known others with Liberty National Securities also, specifically, Dave Ross and Karen Timmins.
- The person Mr. Hackney calls to place his bond transactions is Karen P. Timmins. He did not know if broker 033, which is reflected on all of the broker invoices, is actually Karen P. Timmins or someone else. He stated that he would find out and inform the examiner.
- Most all bond trades are sales in the morning and buy backs in the afternoon. The Company makes its trades over the telephone rather than through computer.
- When informed that Liberty National Securities, Inc. had provided a confirmation of securities held and that the confirmation form stated that the bonds were not re-deposited elsewhere, Mr. Hackney stated that he was of the opinion that the securities were actually held at the DTC or elsewhere.
- When asked what due diligence he had done in selecting the broker, Mr. Hackney stated that he knew the people and that the broker was a member of SIPC. When shown a copy of the audited financial statement that reflected the brokers approximately \$58,000 net worth, Mr. Hackney indicated that the Company had significant insurance coverage that would cover any broker losses. The examiner expressed doubt that the Company's bond coverage would extend to the broker's actions.

The examiner's confirmation from the broker of securities held at 12/31/97 creates questions because of the following:

- The confirmation was mailed with the required certification forms A, B, and C as well as a listing of the securities held. The request asked that a designation be placed next to each security denoting which confirmation form was applicable. The certification was returned with only form A and without any designations next to the securities. The implication was that all securities were being confirmed to be held in the broker's possession.
- The confirmation required an officer of the firm to sign in two places. Both signatures are made as vice president and treasurer (Karen Timmins), but are obviously different signatures.

Exhibit G

(1) As part of the on-site examination of Franklin American Life Insurance Company for the five-year period ending December 31, 1997, Mr. Billy Lovelady received a custodial affidavit from Liberty National Securities, Inc. The affidavit was allegedly signed by Ms. Karen Timmins, Vice President and Treasurer of Liberty National Securities, Inc. In checking with the department's securities division, Mr. Lovelady discovered that Ms. Timmins was not a registered broker for the brokerage firm. (2) Furthermore, the broker-dealer form filed with the securities division did not disclose a New York City address as stated on the confirmation returned by Ms. Timmins.

2

FORM A  
CUSTODIAN AFFIDAVIT

(For use by a custodian where securities entrusted to its care have not been redeposited elsewhere.)

Karen Timmins being duly sworn deposes and says that he is Vice President and Treasurer of LIBERTY NATIONAL SECURITIES, INC., a brokerage firm organized under and pursuant to the laws of the United States with a principal place of business at New York City, NY (hereinafter called the "broker");

That his duties involve supervision of activities of the broker as custodian and records relating thereto;

That the broker is custodian for certain securities of FRANKLIN AMERICAN LIFE INSURANCE COMPANY having a place of business at FRANKLIN, TENNESSEE (hereinafter called the "insurance company") pursuant to an agreement between the broker and the insurance company;

That the schedule attached hereto is a true and complete statement of securities (other than those caused to be deposited with The Depository Trust Company or like entity or a Federal Reserve Bank under the Federal Reserve book-entry procedure) which were in the custody of the broker for the account of the insurance company as of the close of business on DECEMBER 31, 1997;

That, unless otherwise indicated on the schedule, the next maturing and all subsequent coupons were then either attached to coupon bonds or in the process of collection; and that, unless otherwise shown on the schedule all such securities were in bearer form or in registered form in the name of the insurance company or its nominee or of the broker or its nominee, or were in the process of being registered in such form;

That the broker as custodian has the responsibility for the safekeeping of such securities as that responsibility is specifically set forth in the agreement between the broker as custodian and the insurance company; and

1

That, to the best of his knowledge and belief, unless otherwise shown on the schedule, said securities were the property of said insurance company and were free of all liens, claims or encumbrances whatsoever.

LIBERTY NATIONAL SECURITIES, INC.

BY [Signature]  
Title Vice President and Treasurer

Vice President (or other authorized officer)

Subscribed and sworn to before me this 6th day of NOV 1998, 1998

State of New York County of New York

Notary [Signature] My commission expires JUNE 30, 2000

GARY COHEN  
Notary Public, State of New York  
No. 31-4764739  
Qualified in New York County  
Commission Expires June 30, 2000

8.5  
Insurance 00-12  
17