JOINT SEC/NASD REPORT

ON EXAMINATION FINDINGS REGARDING BROKER-DEALER SALES OF VARIABLE INSURANCE PRODUCTS

Office of Compliance Inspections and Examinations
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JOINT SEC/NASD STAFF REPORT ON EXAMINATION FINDINGS
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I. EXECUTIVE SUMMARY

Variable annuity and variable life insurance products (collectively, "variable insurance products" or "variable products") are being marketed and sold to a large number of investors. While variable insurance products may be appropriate investments for some investors, concerns have been raised about the sale of these products. This prompted the staffs of the Securities and Exchange Commission ("SEC" or "Commission") and NASD ("Staff") to conduct examinations of broker-dealers that sell variable insurance products. This report summarizes the findings of those examinations.

Variable insurance products are hybrid investments containing both securities and insurance features. The insurance features of variable annuities permit the investor to receive a series of periodic payments from the investment over time and provide a death benefit to the beneficiary should the investor die during the accumulation phase. Variable life policies are a form of life insurance. The insurance features of both products provide tax-deferred treatment of any accumulated earnings. In both variable annuity and variable life products, the securities feature provides the investor with an opportunity to participate in potential capital appreciation and income through investments in the securities markets, but also subjects the investor to market risks.

Variable insurance products, as securities under the federal securities laws and insurance under state insurance laws, are sold jointly through broker-dealers and insurance agencies. In selling securities, broker-dealers must comply with a number of requirements including having reasonable grounds for believing that the recommendation is suitable for the investor, providing adequate supervision over salespersons, ensuring that adequate disclosure is made to customers, and maintaining all required books and records.

High commissions, typically above 5% for variable annuities, help drive sales of these products. Variable insurance products have higher fees and surrender charges than mutual funds that provide no insurance features. These high fees and surrender charges combine with other factors to make variable insurance products inappropriate for many investors. The Commission, NASD and other regulators have received a large number of complaints from individual investors about variable insurance products. Many of these complaints indicate that the customer was sold a variable product without fully understanding the product, and express concerns that the product was not appropriate for them, given their investment objectives.

In view of the number of complaints and the unique characteristics of variable insurance products that require special disclosures, controls, and procedures when selling the products, the Staff undertook a number of examinations of broker-dealers to review sales of variable insurance products. These examinations reviewed: the process firms used to ensure that the product was suitable for the investor; the supervision exercised over registered representatives selling the product; relevant disclosure made to investors about the product; the books and records maintained by the firm related to sales of the product; and the training provided to firm employees about the product.

This Staff report identifies examples of both sound and weak practices that were noted during the examinations.[1] This report is not a comprehensive roadmap for compliance and supervision with respect to the sale of variable insurance products, but rather points out examples of common problems that may be encountered, and some measures that firms are using to ensure better compliance. Firms should consider the information in this report in assessing their own systems and procedures and in implementing improvements that are tailored to and work best for their firm. We note that while a particular sound practice may work well for a large firm, the same approach may not be effective or economically feasible for a smaller firm. The reverse is also true. Firms must adopt procedures and controls that are effective given their size, structure and operations. Utilizing the information in this report may be beneficial, but will not establish a safe harbor should problems or violations arise.

In light of the findings from these examinations and recent enforcement actions, NASD recently took steps to propose the adoption of new rules governing the sales of deferred variable annuities. The NASD Board of Governors proposed new requirements tailored specifically to transactions in deferred variable annuities – from new sales practice standards and supervisory requirements to increased disclosure and sales force training. The new rule would codify and make mandatory best-practice guidelines that NASD had previously issued. NASD intends to request public comment on the proposed rule and details of the proposal will be published in a *Notice to Members*. The key requirements expected to be included in the rule proposal are described in an NASD News Release,[2] as summarized below.

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1 This report represents the findings and views of the Staff of the Commission and NASD, and not the Commission itself. For purposes of this report, Staff of the Commission and NASD are collectively referred to as "Staff." In this report, "weak practices" are those which reflect a lack of robust controls to prevent violations of the federal securities laws or Self Regulatory Organization rules and "sound practices" reflect robust controls to help prevent such violations. In some instances, a weak practice may itself constitute a violation.

2 *NASD proposes specific requirements for deferred variable annuity sales* (April 26, 2004), *at* http://www.nasdr.com/news/pr2004/release_04_027.html.

Elements of NASD Rule Proposal

⇒ *Suitability*

In recommending the purchase of a deferred variable annuity, a registered representative would be required to determine that:

- the customer has been informed of the unique features of the variable annuity;
- the customer has a long-term investment objective; and
- the deferred variable annuity as a whole, and its underlying sub accounts, are suitable for the customer, particularly with regard to risk and liquidity.

The registered representative would be required to document these determinations.

⇒ *Disclosure and Prospectus Delivery*

The firm or its representative would be required to provide the customer with a current prospectus and a separate, brief, "plain English" risk disclosure document highlighting the main features of the particular variable annuity transaction. Those features would include:

- liquidity issues, such as potential surrender charges and IRS penalties;
- sales charges;
- fees (including mortality and administrative fees, investment advisory fees and charges for riders or special features);
- federal tax treatment for variable annuities;
- any applicable state and local government premium taxes; and
- market risk.

The risk disclosure document would be required to inform the customer whether a "free look" period applies to the variable annuity contract, during which the customer could terminate the contract without paying any surrender charges and receive a refund of his or her purchase payments.

⇒ *Principal Review*

Before a registered representative could effect any transaction in a deferred variable annuity, a registered principal would be required to review and approve the transaction. The registered principal would be required to consider specific factors (for instance, whether the customer's age or liquidity needs made a long-term investment inappropriate). Before a registered representative could complete a recommended transaction, the registered principal would be required to review and approve, in writing, the suitability analysis document and a separate exchange or replacement document, if the transaction involved an exchange or replacement of an existing variable annuity.

⇒ *Supervisory Procedures*

The rule proposal would require registered firms to establish and maintain specific, written supervisory procedures reasonably designed to achieve compliance with the rule's standards.

⇒ *Training*

Registered broker-dealers would be required to develop and document specific training policies or programs designed to ensure that registered representatives and registered principals comply with the rule's requirements and that they understand the unique features of deferred variable annuities.

II. Background: What are Variable Insurance Products?

Variable insurance products provide investment as well as insurance features. Insurance companies that sponsor variable products place investor monies in segregated asset accounts called "separate accounts" and then invest the funds in the securities markets or in an underlying fund(s). These underlying investments are subject to market risks. Specific features of variable products are described below.

A. Variable Annuities

A variable annuity is a contract between an investor and an insurance company. The company promises to make periodic payments to the contract owner or beneficiary, starting immediately or at some future time, and should the contract owner die during the accumulation phase, a death benefit is paid to the beneficiary. Variable annuities offer choices among a number of complex contract features. For example, contracts may offer various types of death benefits, rebalancing features, dollar cost averaging options, assorted payout structures, and optional riders such as a guaranteed minimum income benefit, estate protection enhancements, or long-term care insurance, in addition to a range of choices among investment options.

B. Variable Life Insurance Products

Variable life insurance is a permanent life insurance policy that builds cash value through the investment of premiums into separate investment options and offers an income tax-free death benefit to the beneficiary. This policy is similar to traditional life insurance, except that the investor has investment choices in connection with the underlying assets. The cost of insurance, as well as other fees and charges, are deducted from the premiums prior to investment into the sub-accounts. The cash value in the sub-accounts will depend on the performance of the underlying securities. If market values of the underlying securities decline, additional premiums may be required to maintain current insurance coverage, and to avoid a lapse of the policy. Variable life insurance is designed for individuals with an actual need for life insurance coverage.

C. Death Benefit

Variable life insurance is a form of life insurance, which pays an income tax-free death benefit to the designated beneficiary upon the death of the insured. Variable annuities may also provide a death benefit. This feature is a guarantee from the insurance company that when the owner or annuitant of the annuity dies, the insurance company will pay a certain amount to the specified beneficiary. The amount of the death benefit provided by a variable annuity is typically at least the total amount invested minus any withdrawals taken, even if the market value of the assets in the contract has declined since the purchase. For additional fees, there may be variations on the death benefit, such as annual or periodic "step-up" features that cause the amount of the guaranteed death benefit to increase to the current market value of the assets in the variable annuity at the designated point in time each quarter, year, or specified number of years.

D. Annuitization

Variable annuity contracts provide for a series of payments to be made to a person named as the annuitant on the contract. Payments can begin immediately or after a certain period of time. There are various payment options, one of which usually includes a monthly payment from the insurance company for as long as the annuitant lives.

E. Fees

Variable products may have a variety of fees. Annual fees based on the value of the contract can be substantial. Average annual expenses of a variable annuity have been estimated by various sources to be in a range from 1.3% to 2.2% of the underlying assets in the account.[3] SmartMoney.com (citing Morningstar) recently compared the average annual expense charge on variable annuity subaccounts with those in mutual funds. The article stated that the average annual expense charge on variable annuity subaccounts has been increasing, and is currently 2.3% of assets, including fund expenses and insurance expenses. The average mutual fund, in contrast, charges 1.44%.[4]

Fees may include:

- *Surrender charges*, which are incurred if the owner withdraws money from the annuity before a specified period (often seven to nine years). Surrender charges usually start at around 6-8% of the amount invested and decline gradually to zero over a period of several years;

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[3] *See* ANDREA COOMBES, *Perfect tool – For a select few: Variable annuities have limited use, Schwab study finds*, CBS MarketWatch.com (Nov. 8, 2002) *at* http://cbs.marketwatch.com/news/story.asp?guid=%7BD2491D4F%2D2437%2D4B24%2DB2B9%2D7632D632843F%7D&siteid=mktw. *See also* JOHN P. HUGGARD, J.D., C.F.P., INVESTING WITH VARIABLE ANNUITIES §703, p. 27 (2002).

[4] *What's Wrong With Variable Annuities?* SmartMoney.com (2004) *at* http://www.smartmoney.com/retirement/investing/index.cfm?story=wrongannuities.

- *Charges for riders or special features,* such as an enhanced death benefit or a guaranteed minimum income benefit;
- *Mortality and expense risk charges,* which the insurance company charges for the insurance risk it takes under the contract;
- *Front end and back end loads*, which are charged by the insurance company sponsor;
- *Administrative fees,* for record keeping and other administrative expenses;
- *Advisory fees,* paid to the investment advisers who manage the underlying funds;
- *Distribution fees, including 12b-1 fees*, paid by the fund to the broker-dealer to reimburse costs of distribution; and
- *Other underlying fund expenses* relating to the investment options.

F. Tax Treatment

One benefit of variable insurance products is favorable tax treatment under the Internal Revenue Code ("IRC"). Investors should consult their tax advisors to fully understand these potential benefits.

Purchasers of variable insurance products can direct their premiums to various underlying investment portfolios (generally investment companies or funds) established in the separate accounts, which in turn invest in the stock market. The tax-deferral feature enables investors to transfer money between investment options available under the contract without incurring a tax liability at the time of transfer. Earnings in both variable annuities and variable life products accumulate on a tax-deferred basis.

While variable products provide tax-deferral features, the insurance company issuer may limit early withdrawals, and withdrawals may have adverse tax consequences. The IRC requires (in most cases) that earnings withdrawn from a variable annuity contract before the customer reaches 59-1/2 be subject to a 10 percent penalty. Limitations that apply to variable annuities differ from those applicable to contributions to certain retirement accounts, such as Individual Retirement Accounts ("IRA") or 401(k) accounts.

Death benefits on variable life insurance policies generally are received by the beneficiary income tax-free. However, variable annuity earnings are subject to ordinary income taxes, not capital gains rates (which may be lower) when they are paid out. Upon inheritance, a beneficiary will pay taxes at ordinary income rates on the earnings of a variable annuity. In comparison, assets such as stock would be inherited at the stepped-up basis as of the date of death of the owner. As a result, the beneficiary would pay lower taxes on earnings upon the sale of stock as compared to the sale of a variable annuity. Both types of assets are subject to inheritance taxes.

III. Examination Findings

A. Suitability, Sales Practices, and Conflicts of Interests

A broker-dealer recommending a variable product to an investor must assess the investor's financial status, investment objectives, and other relevant information to determine if the product is suitable. The obligation to recommend only securities that are suitable for the customer arises from the antifraud provisions of the federal securities laws, and from rules of the self-regulatory organizations ("SROs"). A broker-dealer, by hanging out its "shingle" and conducting a public securities business, impliedly represents that it will deal fairly with customers.[5] As part of this obligation of fair dealing, broker-dealers must have a reasonable basis for believing that their securities recommendations are suitable for the customer in light of the customer's financial needs, objectives and circumstances. In addition, broker-dealers must have a reasonable basis for believing that the particular security being recommended is appropriate. Under NASD Rule 2310 and IM 2310-2, when a broker-dealer recommends a security to a customer, it must determine that the security is suitable for that customer in light of that customer's particular age, financial situation, risk tolerance, and investment objectives. Because variable annuities and variable life insurance are complex products, the NASD has issued additional guidance in assessing the suitability of recommendations of variable products in Notices to Members ("NTM") 96-86, 99-35, and 00-44.

In addition to existing securities laws and rules governing suitability, the National Association of Insurance Commissioners ("NAIC") has expressed concern regarding the sale of variable annuities to seniors. As a result of these concerns, on September 14, 2003 the NAIC adopted a Model Regulation entitled Senior Protection in Annuity Transactions. The model regulation, which was adopted as a model for state legislation, requires insurers and producers to use standards similar to those required by the NASD for variable products to evaluate the suitability of recommendations.

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5 *See* 1963 Special Study of the Securities Markets, H.R. Doc. 95, 88th Cong., 1st Sess. (1963) (the "Special Study of the Securities Markets") at 238; *see also* Richard N. Cea, 44 S.E.C. 8, 18 (1969), and Mac Robbins & Co., 41 S.E.C. 116 (1962). In addition, in 1994 the Commission stated that suitability should be considered as a facet of the shingle theory and is part of the obligation every broker-dealer owes to every customer. Investment Advisers Act Release No. 1406 (March 16, 1994), 59 Fed. Reg. 13464, 13465 n. 6 (March 22, 1994).

Described below are examples of both weak and sound practices identified by examiners relating to firms' suitability practices.

1. Weak practices noted

⇒ *Unsuitable variable product recommendations were made without a reasonable basis in light of information the broker may have had regarding the customer's*:

- Age;
- Financial or tax status (*e.g.,* sales that exceed a pre-determined percentage of the customer's net worth; sales that require the mortgage of a home to finance the purchase; sales that require a customer to borrow from an existing life insurance policy or annuity; or sales to a corporation, trust, or other non-natural entity that did not hold as agent for a natural person, and whose purchase therefore caused the loss of tax-deferral status in the annuity);
- Investment objectives (*e.g.,* same product recommended to all customers (one size fits all), or a customer's current need for income);
- Investment sophistication and ability to understand the complexity of variable products generally, and to monitor the investment of the separate account;
- Low risk tolerance (*e.g.,* high risk equity funds are recommended to an investor with low risk tolerance);
- Need for liquidity (*e.g.,* sale of an illiquid variable product to persons who need their funds soon, and as a result incur surrender charges to obtain their funds);
- Lack of need or desire for life insurance;
- Ineligibility under the terms of the prospectus; and
- Other relevant information, such as investments made for college planning, despite the fact that the owner-parent would not reach age 59-1/2 before the child would begin college (surrender charges and tax penalties associated with withdrawal from a variable annuity may make the product prohibitively expensive for such a purpose).

⇒ *Unsuitable switching or replacement*:

- Registered representatives gave unfounded, false or misleading justifications for switches or replacements;
- Registered representatives misrepresented or failed to inform clients of sales charges associated with switches or replacements; and
- Excessive switching of variable annuities took place in customer accounts, often on a periodic basis, once every 2-3 years.

⇒ *Inadequate policies and procedures*:

- Guidance was not provided to registered representatives regarding the factors to consider in determining the suitability of variable products or underlying funds;
- Procedures and controls did not require that a registered representative collect all information required to conduct a suitability analysis;
- Procedures did not require that the suitability analysis be documented;
- Procedures and controls did not detect and prevent excessive switching and other abusive sales practices; and
- Firms did not have controls in place to protect against abusive practices related to conflicts of interests.

⇒ *Inadequate supervisory reviews*:

- Correspondence, including e-mails and instant messaging, was not reviewed closely enough by a principal to identify unfounded, false, or misleading justifications for switches or replacements;
- Firms did not require supervisors to review the suitability of recommendations or sales; and
- Firms did not utilize compliance systems, such as computer-generated exception reports, to identify patterns of abusive sales practices by their registered representatives. (S*ee* Appendix A for examples of such exception reports.)[6]

2. Sound Practices

⇒ *Practices to foster suitable investments:*

- Firms required registered representatives to document each sale with a suitability checklist that evidenced the suitability determination;
- Firms assessed and made recommendations based on the liquidity needs of their customers; those with short-term investment objectives were advised that variable annuities were not suitable because they are long-term investments;
- If an investment did not seem to meet the customer's needs and objectives (*e.g.,* if the investments in variable products

6 Exception reports include reports that identify exceptional numerical occurrences, such as frequent trading in customer accounts, unusually high commissions, or an unusually high number of trade corrections or cancelled transactions. These reports help supervisors, compliance officers, and securities regulators to discover sales practice problems such as excessive switching, unauthorized trading, and other indications of securities fraud.

totaled more than a certain percentage of the customer's net worth, or the investment objectives did not fit with the choice of a variable product), firms contacted the customer for current information, assessed suitability based on that information, and advised the customer not to purchase the product where it appeared unsuitable;

- Firms implemented controls to prevent their registered representatives from inappropriately recommending that a customer mortgage their home for the purchase of variable annuities or variable life insurance; and
- Suitability determinations were made at two levels: the contract level and the underlying fund level.

⇒ *Selection and review of investment advisers:*

- In selecting or recommending an investment adviser for asset allocation within the variable annuity, or for wrap and managed account programs to purchase and hold variable annuities, the firm and registered representative had a reasonable basis for the recommendation, based on due diligence done on the investment adviser;
- Regular reviews were conducted to evaluate advisers and terminate contracts with those that no longer met firm standards;
- Only variable annuities with reduced advisory fees, designed especially for wrap accounts, were offered to investors purchasing within wrap accounts. Investors received periodic investment advice regarding the allocation of assets within the wrap account, including allocations among underlying funds of the variable annuity held in the wrap account; and
- Reports were generated comparing asset-based fees charged in a brokerage account to commissions that would have been generated in the same account over the same time period, and these reports were considered as part of a periodic review of the appropriateness of such fee-based accounts. (Note: When variable products are held in fee-based accounts, the customer may be charged more than if the same products were held in commission-based accounts. The additional expense is unnecessary unless the customer receives an additional benefit, such as investment advice.)

⇒ *Comprehensive policies and procedures:*

- Firms implemented written suitability guidelines specifically for variable products, and guidelines addressed the steps necessary to obtain the required customer information;

- Firms provided written guidance to registered representatives regarding their analysis of the customer's financial situation and objectives, review of the product's features with the customer, discussion of key issues with the customer, providing an adequate trail of documentation, and performing a comprehensive supervisory review;
- Firms implemented procedures to screen for specific suitability issues, including age, allocations that did not match investment objectives, variable product investments exceeding a certain percentage of the customer's liquid net worth, more than a specified dollar amount invested in a variable annuity, the purchase of a variable annuity for college tuition payments when the owner's age would cause planned distributions to be taxable, and variable life financing;
- Firms implemented procedures to prevent unsuitable sales of variable annuities in an IRA, 401(k), or other tax-qualified accounts;
- Firms' procedures provided suitability screening *before* transactions took place;
- Firms implemented procedures requiring the use of specified formulae for analysis of accounts, which helped them to avoid excessive switching in customer accounts. Firms identified exchange transactions that occurred within a certain period of time after the prior purchase, and analyzed the costs of surrendering any prior product, compared to the benefits of investing in a new product, on a careful, mathematical basis; and
- Firms implemented effective procedures to identify, assess, monitor and control conflicts of interests.

⇒ *Review of communications:*

- E-mails, instant messaging and other correspondence were promptly reviewed by a principal, with a view to identifying unfounded, false, or misleading representations.

⇒ *Systems:*

- An automated system was implemented to facilitate a comparison of sales recommendations with the client's suitability profile to assure that sales were consistent with the client's investment objectives and risk tolerance, down to the underlying fund level;
- An electronic order system was implemented to reject new orders if the client's suitability profile was not complete and up-to-date; and

- Exception reports were generated to flag sales of variable products that raised concerns and these reports were used for supervisory purposes. (*See* Appendix A for examples of exception reports.)

B. Supervision

Section 15(b)(4)(E) of the Exchange Act authorizes the Commission to censure or revoke the registration of any broker-dealer that has failed to supervise another person who commits a violation of the federal securities laws, rules, or regulations. Section 15(b)(6)(A) of the Exchange Act authorizes the Commission to censure, suspend, or bar from association with a broker or dealer, a person who has been convicted of an offense or otherwise violated certain rules, as specified in the statute. NASD Rule 3010(a) and NYSE Rule 342 require broker-dealers to supervise their employees in a way that is reasonably designed to achieve compliance with the securities laws, rules, and regulations. NASD Rule 3010(b) also requires broker-dealers to establish, maintain, and enforce written procedures to supervise the type of business in which the firm is engaged. A broker-dealer must obtain information about and supervise the activities of registered representatives who receive selling compensation for activities as set forth in NASD Rule 3040.

1. Weak practices noted

⇒ *Inadequate written supervisory procedures:*

- Procedures did not adequately address the firm's variable product business;
- Common problems included:
  - no requirement to ascertain customer objectives;
  - no requirement to determine whether the product is suitable;
  - no requirement to review allocation of premium payments to the underlying funds; and
  - no procedures for remedial measures for problem registered representatives.
- Procedures were not updated to address the firm's growing variable product business; and
- Procedures did not adequately provide for the identification of customer correspondence as complaints.

⇒ *Supervisory failures*:

- Supervisors failed to review transactions;
- Supervisors failed to approve transactions;
- Supervisors did not investigate red flags adequately (*e.g.*, when a pattern of excessive switching was identified, the supervisor relied on information provided by the registered representative, rather than obtaining other, objective

information; and when a registered representative said that he switched products to lock in a higher death benefit, the supervisor failed to ask if the customer was concerned about assets for himself or his heirs);

- Firms failed to put registered representative on heightened supervision after indications of abusive sales practices or other problems were identified; and
- Firms did not identify and prevent manipulative and abusive sales practices, or fraudulent and unsuitable sales to market timers, hedge funds, and other customers.

⇒ *Documentation failures:*

- Evidence of supervisory review and approval, such as a principal's signature, was missing from New Account forms, order tickets, and other documents that require a record of supervisory approval; and
- Firms' account documents did not include customers' net income, net worth (exclusive of primary residence) or investment objectives and other information, which could have been used by the broker-dealer to make a suitability determination.

⇒ *Systems failures*:

- Firms did not employ systems to assure their written supervisory procedures were enforced;
- Firms did not monitor variable product sales activities of their registered representatives, through exception reports or otherwise, thereby limiting their ability to supervise; and
- Firms did not use reports and services from insurance company issuers of variable products or clearing firms that would assist in supervision.

2. Sound Practices

⇒ *Comprehensive written supervisory procedures*:

- Procedures were updated to keep pace with the firm's developing businesses, as well as changes in the law, new rules, and NASD NTMs;
- Procedures included:
  - detailed description of responsibilities of registered principals and other supervisors, including for reviewing transactions for suitability, verification of customer information, and approval of transactions;
  - guidelines describing when recommendations require scrutiny, such as sales to individuals over

a particular age, customers requiring immediate income or access to funds, customers desiring guarantees against loss of their principal, or sales of variable products in amounts that exceed a pre-determined percentage of net worth;

- guidelines requiring that when certain parameters were present (including when the customer was over a specified age, when the transaction would take place in a tax-qualified account, and when the transaction was a switch where the previous product had been held less than a specified time period), the firm would require pre-approval of the transaction by a centralized second-tier review unit;
- information registered representatives must consider in conducting a suitability analysis regarding the features of variable products, including tax consequences, types and general ranges of fees, insurance aspects (*e.g.,* death benefits, living benefits, potential lapse of coverage, etc.);
- a comprehensive list of documents registered representatives must use in the sale of variable products;
- guidelines describing how the required documents were to be used and which documents were required with each sale;
- methods to objectively analyze the benefits of a variable product over alternative investments (*e.g.,* cost analysis, unique product features), and specific standards or guidelines to be followed regarding when it is appropriate to recommend the initial sale of a variable product, the exchange of a product, and the purchase or the sale of a variable annuity within an IRA, 401(k), or other tax-qualified account;
- steps for the timing of document completion (before the sale, after the sale, etc.); and
- guidelines indicating when the supervisor or the firm would contact a customer to verify that the recommendation was suitable.

⇒ *Supervision:*

- Supervisors reviewed every sale of a variable product to ensure that it was appropriate;
- When indications of abusive sales practices or violations were identified, firms quickly investigated the issue and took appropriate action (*e.g.*, putting employees on heightened supervision, suspending, fining or terminating them), and also determined whether supervisors reasonably carried out their responsibilities;
- Firms reviewed their supervisory systems and procedures to determine whether an identified weakness, deficiency, or apparent violation was indicative of a defect in the firm's system of supervision or its written supervisory procedures;
- Supervisors reviewed the allocation of premium payments to the underlying funds;
- Supervisors reviewed hypothetical illustrations to ensure assumed rates of return (*e.g.*, 6%, 12%) were indicative of current markets and reflective of appropriate assumptions;
- A centralized second-tier review unit was established at headquarters to review suitability of all variable insurance product transactions and to reject inappropriate transactions, including analyzing activity and providing reports to branch managers on replacement and exchange activity;
- Complaints were responded to timely and appropriately, were actively monitored, and were sorted by product and problem types, as well as by branch and registered representative, to facilitate reviews; and
- Comprehensive reports were produced on a periodic basis, which analyzed trends in complaints received.

⇒ *Systems:*

- Automated systems were implemented to detect and prevent improper and excessive financed and replacement sales of variable life insurance products;
- Exception reports were comprehensive and tailored to identify potential problems involving sales of variable products (see Appendix A for examples); and
- Introducing firms and clearing firms worked together to create effective reports, and reports from insurance issuers were used to gather complete information, to identify problems.

C. Disclosure

Broker-dealers selling variable products to customers must act in accordance with the just and equitable principles of trade provided by NASD rules. Moreover, they have general agency duties. For example, they have an obligation to disclose to customers any material conflict of interests. Failure to disclose material conflicts may constitute a violation of the general antifraud provisions of the federal securities laws under Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Exchange Act of 1934 ("Exchange Act").

A broker-dealer is required to deliver a prospectus on or before the transaction settlement date (Section 5(b)(2) of the Securities Act). Antifraud provisions of the federal securities laws prohibit making misrepresentations or omissions of material facts in the purchase, offer or sale of securities (Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act, as well as Rule 10b-5 under the Exchange Act). Broker-dealers are required to maintain documentation of any written disclosure made to customers (Rule 17a-4(b)(4) under the Exchange Act).[7]

The NASD has provided guidance to broker-dealers regarding disclosures that broker-dealers should make to customers investing in variable insurance products.[8] This guidance states that to the extent practical, registered representatives should provide a current prospectus to customers when recommending a variable life insurance policy or variable annuity contract. Registered representatives should be available to discuss the information that is contained in the prospectus. Firms may also wish to provide customers with firm-approved product information brochures that explain the features and principal risks associated with variable life insurance. Registered representatives should discuss with the customer all relevant facts such as fees and expenses (including mortality and expense charges, administrative charges, and investment advisory fees); the lack of liquidity of these products, (including issues such as potential surrender charges and the federal tax penalty); any applicable state and local government premium taxes; and market risk. The NASD suggests that the registered representative should make sure that the customer understands the effect of surrender charges on redemptions and that a withdrawal prior to the age of 59-1/2 could result in a withdrawal tax penalty, and should also make sure that customers who are 59-1/2 or older are informed when surrender charges apply to withdrawals. Moreover, the NASD suggests that any communication discussing the tax-deferral benefits of variable life insurance should not mislead the investor by obscuring or diminishing the importance of the life insurance features of the product, or by overemphasizing the investment aspects of the policy or potential

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[7] In addition, the SEC has proposed a new point-of-sale disclosure rule, Proposed Rule 15c2-3 under the Exchange Act, which would require additional disclosure, beyond that currently required, of material information regarding unit investment trusts (including variable annuities) prior to the transaction. The proposed new point-of-sale disclosure rule would require broker-dealers to provide point-of-sale disclosure to customers about costs and conflicts of interests. *See* Confirmation Requirements and Point of Sale Disclosure Requirements, Securities Act Release 33-8358 (January 29, 2004) *at* http://www.sec.gov/rules/proposed/33-8358.htm.

[8] *See* NASD NTMs 96-86, 99-35, and 00-44.

performance of the subaccounts. With regard to sales of annuities in tax-qualified plans, the NASD states that when a registered representative recommends the purchase of a variable annuity for any tax-qualified retirement account (*e.g.*, 401(k) plan, IRA), the registered representative should disclose to the customer that the tax-deferred accrual feature is provided by the tax-qualified retirement plan and that the tax-deferred accrual feature of the variable annuity is unnecessary.

NASD suggests that the member firm may decide to develop an exchange or replacement analysis document or utilize an existing form authorized by a state insurance commission or other regulatory agency for variable product replacement sales. If such a document is used, then (consistent with the requirements of various states) the appropriate form should be completed for all variable annuity and variable life insurance replacements, and it should include an explanation of the benefits of replacing one contract or policy with another. The customer, the registered representative, and the registered principal should sign the document.

Finally, when financing is recommended, the NASD recommends that registered representatives should disclose to the life insurance policy owner the potential consequences to both the existing and new policy. Members should provide a form to the registered representative that documents the customer's informed consent to the financing. The form should include the customer's acknowledgement, the registered representative's signature, and a registered principal's signature. (NASD NTM 00-44).

Under NASD Rule 2110, it is unethical conduct to circumvent any state law or other SRO regulations related to exchange transactions, including disclosure requirements such as N.Y.S. Insurance Code Regulation 60.

In some cases, the broker-dealer may also be a registered investment adviser, or may be acting as a solicitor for an investment adviser. These activities may impose a duty to disclose receipt of special compensation or compensation from third parties. Additional disclosure issues arise with respect to the sale of variable annuity products in wrap accounts and managed accounts. (*See* Investment Advisers Act of 1940 ("Advisers Act") Section 206. *See also* Rule 206(4)-3 under the Advisers Act, and NASD NTM 03-68).

1. Weak practices noted

⇒ *Firms failed to disclose:*

- Fees:
    - the nature of the product and the fact that it bears additional costs and expenses associated with its insurance features, such as Mortality and Expense (M&E) charges, cost of insurance (COI) charges, and administrative fees; and

    - the amount of any advisory, management, or wrap fees, whether they are included within the structure of the variable product or are charged to the account.
- Risks:
    - potential market losses due to market declines;
    - investment decisions;
    - interest rates in fixed account; and
    - issuer financial strength risk.
- Lack of liquidity of variable products:
    - the amount of surrender charges and length of surrender period, both in the initial purchase of a variable product and in the exchange of an existing variable product (particularly when a bonus product is being sold as a replacement).
- Guaranteed death benefit:
    - the fact that a “guaranteed death benefit” of a variable product accrues to the beneficiaries only upon the death of the annuitant or insured.
- Tax implications:
    - tax disadvantages of a variable annuity, such as tax on any increase in value at ordinary income rates upon distribution, and inclusion of the entire value of the annuity in calculation of the estate tax;
    - estate tax consequences of naming the insured as the owner of a variable life policy;
    - lack of additional tax benefit when purchasing a variable annuity in an IRA, 401(k), or other tax-qualified account; and
    - tax treatment of withdrawals and loans should a policy become a Modified Endowment Contract (MEC).
- Potential consequences of financing a variable product:
    - the fact that borrowing against cash value in an existing life policy or annuity will deplete the cash value;
    - the fact that the new policy will lapse if premiums cannot be paid;
    - the interest rate risk associated with any variable rate loan; and
    - that investment returns may not be sufficient to pay mortgage payments if home equity is used to finance the purchase of a variable product.

⇒ *Undisclosed conflicts of interests:*

- Investment advisers were recommended for asset allocation services within variable annuities in conjunction with wrap or managed accounts programs, based on affiliation with or expected payments to the broker-dealer, rather than on the adviser's ability to assist the investor.

⇒ *Inadequate disclosure procedures and controls:*

- controls did not require registered representatives to provide full, clear, and balanced disclosure to customers, including features, benefits, fees (including double layer of advisory fees for wrap and managed accounts), length of surrender periods, amount of surrender charges, and other information, presented in plain English.

2. Sound Practices

⇒ *Specific disclosures were made about:*

- Fees:
  - full and balanced disclosure of the features, benefits, fees, charges, and surrender period of the recommended variable product;
  - comparison of the features, benefits, fees, charges, and surrender periods of the old and new products in an exchange transaction; and
  - the need to maintain sufficient cash or other liquid assets in a managed account to cover management or wrap fees, so the investor will not incur unnecessary surrender charges and tax penalties for fees that were foreseeable at the time the product was sold.
- Risks:
  - potential market losses due to market declines;
  - investment decisions;
  - interest rates in fixed account; and
  - issuer financial strength risk.
- Tax implications:
  - disclosure in connection with sales within qualified accounts, *i.e.*, that the tax-deferral feature may be redundant and that there must be a good reason (other than tax-deferral) for recommending the purchase.

⇒ *Procedures and controls:*

- Firms required their registered representatives to provide the prospectus for the variable product (and where possible, for any underlying funds that were recommended) at the point of sale and required a prospectus delivery receipt signed by the client (even though prospectus delivery is legally required only at settlement of the transaction);

- Procedures provided a description of how the disclosures were to be made and what evidence was required, such as a prospectus receipt signed by the customer;
- Forms were provided for disclosure purposes and the information required on those forms was detailed in plain English;
- Firms informed their registered representatives that if no documentation of disclosure to or of a conversation with a client exists, the firm assumes that the disclosure was never provided, or the conversation never occurred;
- Customers were referred to information about investing in variable products and investing risks on the SEC and NASD websites or were given these materials; and
- Firms used a disclosure and comparison form to disclose to customers in full, clear, and balanced terms the features, benefits, fees, risks, surrender periods, and financing risks of variable product transactions.

D. Books and Records

Broker-dealers are required to make and keep certain records (Rules 17a-3 and 17a-4 of the Exchange Act). These rules were recently amended to require, among other things, that broker-dealers obtain updated information about their customers' investment objectives on a periodic basis, and that they maintain or make available certain information at branch offices (*see* Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-44992 (October 26, 2001) and Final Rule Correction Exchange Act Release No. 34-44992A (March 26, 2003)). The Commission also recently issued an Interpretive Release regarding these rules that describes, among other things, the application of the daily blotter requirement to variable product transactions (Exchange Act Release No. 34-47910 (May 22, 2003), 68 FR 32307 (May 29, 2003) at http://www.sec.gov/rules/interp/34-47910.htm). A broker-dealer may also be required to create or maintain additional records pursuant to the rules of the SROs (*e.g.,* NASD Rules 3110 and 2310). Among other things, a broker-dealer effecting transactions in variable products must create and maintain a purchase and sales blotter, order tickets, and customer account information.

1. Weak practices noted

⇒ *Customer information:*

- Customer information was not obtained or maintained as required, with the result that the suitability of recommendations could not be determined, and adequate supervision could not be performed.

⇒ *Suitability:*

- Documentation supporting recommendations of variable products to customers was not maintained; and
- Exchange or replacement analysis documents did not include an explanation of the benefits of replacing one contract or policy with another, did not request the customer's reason for the replacement, or did not require the customer's signature.

⇒ *Disclosure:*

- Little or no documentation was maintained of disclosure to customers of variable products' fees, risks and expenses.

⇒ *Written supervisory procedures:*

- Firms failed to prepare or maintain documents or forms that were called for in their internal procedures.

⇒ *Complete daily blotter:*

- Purchases and sales of variable insurance products were not captured in the daily blotter.

⇒ *Complete orders:*

- Order information was not captured on order tickets, or order tickets were not created and maintained.

⇒ *Customer complaints:*

- Customer complaints were not reported to the NASD as required;
- Customer complaints were not always analyzed, researched, and acted upon in a timely manner.

2. Sound practices

⇒ *Customer information*:

- A new account form was obtained and maintained on file for each customer, along with application or order forms for each transaction; and
- Updated client information was obtained on a regular basis.

⇒ *Suitability:*

- Firms were able to evidence their suitability determinations and reviews because they maintained customer information used to support each recommendation, including purchases of

variable annuities in an IRA, 401(k), or other tax-qualified account; and
- Forms used to document the customer's reason for switching required that the reasons be written out and signed by the customer, rather than simply providing a checklist for the customer to choose from.

⇒ *Disclosure*:
- Full and complete documentation of written disclosures made to the customer was maintained.

⇒ *Daily blotter:*
- Transaction information was maintained for all purchase and sale transactions in all variable products, including both sides of exchange transactions.

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⇒ *Orders:*
- Information regarding all orders, whether executed or unexecuted, including orders that were withdrawn, cancelled, or rejected, was created and maintained.

⇒ C*ustomer complaints:*
- Customer complaints were reported appropriately to the NASD or other SRO; and
- Customer complaints were analyzed, researched, and acted upon in a timely manner.

E. Training

Examiners found that many deficiencies resulted from inadequate or inappropriate[9] training of firm employees. Given the complexity of the product, it is critical that broker-

[9] The Staff of the SEC and NASD are reviewing the participation of registered representatives in sales training seminars designed to teach aggressive techniques for selling variable products to the elderly. The State of Massachusetts recently issued an Elder Alert alerting investors to potential fraud in investment seminars. Earlier, on September 25, 2002, the state brought an administrative action, *In the Matter of Tyrone M. Clark, Brokers Choice of America, Senior Benefit Centers Network,* Mass. Securities Div., Adm. Complaint #E 2002-47, alleging that the respondents recruited and trained individuals to act as its unregistered investment adviser representatives, specifically to target the elderly and to coerce them into selling their securities holdings to purchase annuities, paying exorbitant commissions. The complaint alleges that respondents utilized "Senior Financial Survival Workshops" as part of an unethical and dishonest scheme to deceive, coerce, and frighten the elderly into purchasing annuities through Brokers Choice of America. The Staff of the SEC and NASD are concerned that, if these allegations are true, some of these training firms may be aiding and abetting the fraudulent sale of securities under Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5.

dealers ensure that their registered representatives and supervisors have adequate training to carry out their responsibilities regarding the sale of variable products.

1. Weak practices noted

⇒ *Inadequate coverage of training program:*

- Training programs did not address the sale or supervision of variable products;
- Firms provided general training to registered representatives that did not cover special features of variable annuities or specific suitability issues;
- The supervisor reviewing variable transactions was not sufficiently trained or experienced to identify abusive sales practices; and
- Annual compliance meetings and "firm element" continuing education programs did not include information on the sale of variable products.

2. Sound Practices

⇒ *Comprehensive training:*

- The training program effectively addressed the sale of variable products, to ensure that all registered representatives were adequately trained to carry out their responsibilities regarding the sale of variable products;
- Training covered who was responsible for conducting the suitability analysis, a description of how this was to be done, when it would be done, and how it would be evidenced;
- Firms provided special training for supervisors to enable them to oversee variable product sales and identify problems; and
- Firms provided regular periodic training on variable products and the firm's procedures with regard to their sale.

⇒ *Supervision of training:*

- There were appropriate measures for supervision of registered representatives' attendance at sales training seminars;
- Broker-dealers carefully reviewed proposed external training seminars so they were comfortable that the content would not encourage inappropriate or unethical behavior; and
- If firms were concerned about external seminars their representative may have attended, special attention was given to the review and approval of those representatives' transactions following the training.

IV. Recent Enforcement Cases

The SEC and NASD have recently brought a number of enforcement actions involving the sale of variable annuities. These actions involved excessive switching, misleading marketing, failure to disclose material facts, unsuitable sales, inadequate written supervisory procedures, failure to maintain adequate documentation, and/or failure to supervise variable product transactions. A summary describing recent enforcement cases brought by the SEC and the Commission is available on the NASD website at http://www.nasdr.com/white_paper_0600804_apen.asp.

V. Conclusions

As the Report on the Joint Regulatory Sales Practice Sweep observed, "[t]he protection of customers from sales practice abuses or other financial harm is critical to maintaining a healthy securities industry." [10] Examinations conducted by the SEC and NASD indicate that firms can take steps to improve their compliance and supervisory practices in selling variable products. Examples of sound practices and weak practices are described in this report. The Staff of the Commission and NASD urge firms to consider the sound practices summarized in this report and improve their supervisory procedures and compliance systems as appropriate to more effectively reduce potential harm to the investing public.

10 Report on the Joint Regulatory Sales Practice Sweep, prepared by the staff of the NASD, the NYSE, NASAA, and the Commission's Office of Compliance Inspections and Examinations (March 1996), *at* http://www.sec.gov/news/studies/sweeptoc.htm.

APPENDIX A
Examples of Relevant Exception Reports

Examples of exception reports that may be useful in identifying abusive sales practices and violations in the sale of variable insurance products include:

- Client's age over firm's internal maximum;
- Clients with low net worth;
- Clients with low annual income;
- Clients in the lowest tax bracket;
- Clients with limited investment experience;
- Clients with high net worth (VA's may not be appropriate for extremely high net worth individuals);
- Clients whose variable annuity purchases exceed a specified percentage of their net worth;
- Clients whose assets are heavily concentrated in VIPs;
- Representatives with a large number of elderly clients of modest means, or with limited investment experience;
- Sales to accounts of non-natural persons (trusts, corporations);
- Comparison of investment choices to customer's investment objectives;
- Variable annuities in an IRA, 401(k), or other tax-qualified accounts;
- Variable annuities in wrap accounts;
- Free look cancellations;
- Surrenders;
- Charge backs;
- Replacements with large surrender charges;
- Surrender charge and other costs of exchange exceed bonus and other benefits received;
- Transactions where surrender took place shortly before a lower surrender charge would have taken effect;
- Underlying fund transactions for market timing activity and late trading activities;
- Short holding period (one to five years);
- Registered representatives with a high percentage of replacements and 1035 exchanges;
- Representatives who repeatedly switched clients after comparatively short holding periods;
- Lapses in variable life insurance for non-payment of premiums;
- Variable life insurance sales with premium payments exceeding a certain percentage of annual income;
- Loans from variable life policies; and
- New variable life policies were matched with disbursements from existing life insurance policies or annuities to track that activity.

Appendix B

References and Resources

Compensation:

NASD Conduct Rule 2820

Suitability:

Securities Act of 1933, Section 17(a)
Securities Exchange Act of 1934, Section 10(b)
Securities Exchange Act of 1934, Rule 10b-5
NASD Conduct Rule 2310
NASD IM-2310-2
NASD Notice to Members 96-86
NASD Notice to Members 99-35
NASD Notice to Members 00-44
NASD Notice to Members 03-68

Supervision:

Securities Exchange Act of 1934, Rule 15(b)(4)(E)
NASD Conduct Rule 3010
NASD Conduct Rule 3040
NASD Notice to Members 99-45
NASD Notice to Members 03-49

Disclosure:

Securities Act of 1933, Section 5(b)(2)

Exchange Act Release No. 34-49148 (January 29, 2004) at
http://www.sec.gov/rules/proposed/33-8358.htm

NASD Conduct Rule 2210(d)
NASD Notice to Members 99-35
NASD Notice to Members 00-44
NASD Notice to Members 03-68

Books and Records:

Securities Exchange Act of 1934, Section 17(a)
Securities Exchange Act of 1934, Rules 17a-3 and 17a-4

Exchange Act Release No. 44992 (October 26, 2001), 66 FR 55818 (Nov. 23, 2001), *at* http://www.sec.gov/rules/final/34-44992.htm

Exchange Act Release No. 47910 (May 22, 2003), 68 FR 32307 (May 29, 2003), *at* http://www.sec.gov/rules/interp/34-47910.htm

NASD Conduct Rule 3110

NASD Conduct Rule 2310

Referral Payments:

Investment Advisers Act of 1940 Section 206
Investment Advisers Act Rule 206-4(3)

SEC No Action Letter re: First of America Brokerage Services, Inc. (Sept. 28, 1995)

Investor Education Materials:

Variable Annuities and Variable Life Products: Questions to Ask
at http://www.sec.gov/investor/pubs/varaquestions.htm

Variable Annuities: What You Should Know
at http://www.sec.gov/investor/pubs/varannty.htm

NASD Investor Alert, Beyond the Hard Sell
at http://www.nasd.com/Investor/Alerts/alert_variable_annuities.htm

NASD Investor Alert, Should You Exchange Your Variable Annuity?
at http://www.nasd.com/Investor/Alerts/alert_annuityexchanges.htm

NASD Investor Alert, Should You Exchange Your Life Insurance Policy?
at http://www.nasd.com/Investor/Alerts/alert_exchange_lifeinsurance.htm

NASD, Equity Indexed Annuities – A Complex Choice
at http://www.nasd.com/Investor/alerts/indexed_annuities.htm

NASD, Investing in a 401(k) – an Investment Menu
at http://www.nasd.com/Investor/Smart/401k/investing 401k/inv1_1j.html

NASD Investor Alert, Betting the Ranch: Risking Your Home to Buy Securities
at http://www.nasd.com/Investor/Alerts/alert_betting_ranch.htm

For additional information, contact:

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