INFORMATIONAL

Variable Contracts

The NASD Reminds Members Of Their Responsibilities Regarding The Sale Of Variable Life Insurance

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Executive Representatives
- Insurance
- Internal Audit
- Legal & Compliance
- Operations
- Registered Representatives
- Senior Management
- Variable Contracts

KEY TOPICS

- Suitability
- Supervision
- Variable Contracts

Executive Summary

Due to the growth in sales and the popularity of variable life insurance products, NASD Regulation, Inc. (NASD Regulation℠) has published this *Notice to Members*, which focuses on retail sales to individuals of variable life insurance. This *Notice* provides a set of guidelines to help members in developing supervisory procedures relating to the sales of variable life insurance. The guidelines identify areas of concern that NASD Regulation would expect to be considered in these procedures.

Questions/Further Information

Questions or comments concerning this *Notice* may be directed to Thomas M. Selman, Vice President, Investment Companies/Corporate Financing, NASD Regulation, at (202) 728-8330; Lawrence Kosciulek, Associate Director, Advertising/Investment Companies Regulation, NASD Regulation, at (202) 728-8329; or Robert J. Smith, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8451.

Background

Variable life insurance and variable annuity contracts (Variable Contracts) are securities, and accordingly, their distribution is subject to National Association of Securities Dealers, Inc. (NASD®) rules. Of particular importance are:

- Rule 3010 (Supervision), which requires each member to establish and maintain systems to supervise the activities of each registered representative and associated person in order to achieve compliance with the securities laws, regulations, and NASD rules; and
- Rule 2310 (Suitability), which requires that a member, when recommending the purchase, sale, or exchange of any security to a customer, have reasonable grounds for believing that the recommendation is suitable for the customer upon the basis of the facts disclosed by the customer.

NASD has published other *Notices to Members* regarding Variable Contracts, including *Notice to Members 99-35* (May 1999) which provides guidance to assist members in developing appropriate procedures relating to deferred variable annuity sales to customers, and *Notice to Members 96-86* (December 1996) which reminds members that sales of Variable Contracts are subject to NASD suitability requirements.

This *Notice* focuses on retail sales of variable life insurance, including both scheduled premium and flexible premium products. The *Notice* provides a set of guidelines to assist members in developing sales-related supervisory procedures.

Description Of Variable Life Insurance

Variable life insurance is an insurance policy that is subject to regulation under state insurance and federal securities laws (unless otherwise indicated, references to variable life insurance include both scheduled premium variable life insurance and flexible premium variable universal life insurance).

Similar to traditional life insurance, variable life insurance offers a death benefit that represents the amount the life insurance company is obligated to pay upon the death of the insured. In addition to the death benefit, variable life

insurance generates an investment element usually termed the "cash value." However, the insurance company that issues the variable life insurance policy does not guarantee the cash value. The cash value and in some cases, the death benefit, can fluctuate based on the performance of investment portfolios maintained by the insurance company in a segregated or separate account, and the interest earned on balances in general account options, if any. Generally, the insurance company guarantees the original face amount of the policy as a death benefit as long as the policy holder's premiums are paid on schedule or the cash value is sufficient to meet each fee deduction.

A customer's variable life insurance premium payments typically are invested in an insurance company's separate account, though in some cases, premiums may also be allocated to one or more general account options. The separate account is distinct from the insurance company's general account, which comprises the assets of the insurance company that issues the policy.

The investment portfolios or investment divisions underlying the separate account are often called "subaccounts." The subaccounts are divisions of the separate account that invest in distinct underlying fund portfolios. A customer's policy premium payments, after deductions for any sales expense charges or premium tax charges, are applied to the subaccounts and any general account options in accordance with the customer's allocation election. The value of the subaccounts will fluctuate in accordance with the investment experience of the underlying funds. Because the policy owners assume investment risks, variable life insurance policies are securities within the meaning of the federal securities laws and must be registered under the Securities Act of 1933, and the separate account and the underlying funds must generally register as investment companies under the Investment Company Act of 1940.

The issuer of the variable life insurance policy is an insurance company. The wholesale or retail distributor of individual variable life insurance policies, which may or may not be related to the insurance company, must register as a broker/dealer under the Securities Exchange Act of 1934 and become a member of the NASD. A person selling individual variable life insurance, in addition to maintaining current life insurance licenses under applicable state laws, must be a registered broker/dealer or a registered representative of a broker/dealer.

Typically the main charges associated with a variable life insurance policy are front-end sales loads, back-end sales loads, administrative charges, cost of insurance charges, mortality and expense risk charges, and various fees associated with each underlying fund option. The cost of insurance charges can vary significantly depending on the individual's personal circumstances (*e.g.*, age, sex, health, smoker/non-smoker, face amount of policy).

Recent Disciplinary Action

In a recent NASD Regulation disciplinary action, an NASD member was found to have violated NASD Rule 3010 (Supervision) for failing to establish, maintain, and enforce reasonable supervisory procedures. The member's procedures failed to adequately differentiate between fixed and variable life insurance products. In addition, the member was found to have violated NASD Rule 2110 (Standards of Commercial Honor and Principles of Trade) for engaging in material misrepresentations and omissions, NASD Rule 2210 (Communications with the Public) for the use of misleading sales literature, and NASD Rule 2310 (Suitability Rule) for unsuitable recommendations and sales. (*See Pruco Securities Corp. Letter of Acceptance Waiver and Consent*[1].) The violations included:

- Various misrepresentations, including statements that:
  - New policies could be acquired by customers already owning the firm's life insurance by using cash values or future dividends from customers' existing policies, for little or no additional cash payment;
  - Premium payments would end, or "vanish," after a certain number of years; and
  - Variable life policies were not insurance but were an investment, savings, or retirement plan.
- Unsuitable sales to customers, including retirees and persons who did not know that they were purchasing insurance or did not want life insurance.
- Failure to establish, maintain, and enforce adequate procedures with respect to the review of variable life insurance purchases to determine whether sales were suitable for customers and failure to obtain the customer information necessary to make suitability determinations.

- Use of misleading sales literature.

- Failure to establish, maintain, and enforce reasonable supervisory procedures.

- Failure to register representatives and principals and permitting unregistered persons to sell securities.

Guidelines For Supervision Of Variable Life Insurance Sales

Variable life insurance may be appropriate for a customer with a need for life insurance and an ability to pay for permanent life insurance protection. Nevertheless, since the cash value and death benefit may fluctuate due to the performance of the investments in the separate account, a variable life insurance customer should also be able to assume investment risk and understand the implications of adverse investment performance.

The following guidelines represent a collection of industry practices regarding the supervision of the sale of variable life insurance. Although these are only guidelines, members are encouraged to refer to them in developing their own policies and procedures relating to variable life insurance sales practices.

A. Customer Information

NASD Rule 2310 requires that members and their registered representatives, prior to the execution of a recommended transaction, make reasonable efforts to obtain information concerning a customer's financial and tax status, investment objectives, and such other information used or considered to be reasonable in making recommendations to the customer. The NASD has recognized that members have developed various practices and procedures in order to comply with this rule.

When recommending a variable life insurance policy, members and their registered representatives should make reasonable efforts to obtain comprehensive customer information, such as the customer's age, annual income, net worth, liquid net worth, number of dependents, investment objective, sources of funds for investment, investment experience, existing investments and life insurance, time horizon, and risk tolerance.

The registered representative should document this type of information in a customer account information form and should submit it with every variable life insurance application. A registered principal should review the account information form and verify that the recommendation of both the policy and the subaccount allocation is consistent with the customer's investment objectives and risk tolerance. Some members have designed policy applications that also contain comprehensive customer background information. Whatever the means by which a member collects customer account information (*e.g.*, in paper or electronic form), appropriate customer account information should be reviewed and retained.

B. Review Of Customer Information

The member should consider whether the customer desires and needs life insurance and whether the customer can afford the premiums likely needed to keep the policy in force.

A member may wish to establish internal percentage ratio guidelines, such as the ratio of scheduled or target premium to income or household income, or percentage scheduled or target premium to liquid net worth. While these ratio guidelines are no substitute for proper supervision, they may assist in the review for variable life insurance affordability and excessive amounts of coverage. If the ratio exceeds the member's parameters, an extra level of supervision and review may be warranted. If parameters are exceeded, the registered representative should submit additional supporting documentation or a written explanation. To assist principals in their review of variable life insurance applications, members may wish to provide a checklist of items for the principal to review.

Members may choose at the point of sale to utilize allocation percentage guidelines when underlying fund allocations are made.

Members may wish to establish special supervision requirements for sales to older customers. Life insurance is often appropriately purchased by older investors. However, variable life insurance may not be suitable for an older investor who is primarily seeking an investment rather than an insurance product. Additionally, members should carefully consider whether an older investor has the financial means to sustain the likely amount of policy premium payments.

C. Product Information

Registered representatives should be thoroughly familiar with the features and costs associated with each recommended variable life insurance policy, including surrender charges, premium and cash value charges, separate account charges, underlying fund fees, subaccount investment

options, loan provisions, free-look periods, and policy premium lapse periods. The registered representative also should be able to clearly convey such information to the customer so that the customer can make an informed investment decision regarding the recommendation.

Variable life insurance policies have features of both traditional insurance products and securities. Accordingly, members may provide their registered representatives with examples, such as lifestyle case studies, to illustrate what the member considers to be potentially unsuitable recommendations and what type of activity would warrant an extra level of supervisory review.

Members may also wish to provide customers with member-approved product information brochures, in addition to any required disclosure documents, that explain the features and principal risks associated with variable life insurance.

To the extent practical, registered representatives should provide customers with a current prospectus when recommending a variable life insurance policy. Registered representatives should be available to discuss with customers the information that is contained in the prospectus.

D. Variable Life Insurance Replacements

Various states have issued rules governing variable life insurance replacement activity. While the definitions vary, the term "replacement" generally refers to the activity of a customer surrendering or altering existing insurance coverage in order to purchase a new variable life insurance policy. A replacement may not be in the best interests of a customer. For example, a customer may incur new fees, extended surrender charge periods, a possible higher insurance risk rating due to ill health, and new suicide and incontestability periods. There may also be unfavorable tax consequences. Registered representatives should carefully consider whether a replacement is in the best interests of the customer.

Members should adopt procedures for the review of replacement recommendations to ensure that they are suitable. Members should either develop a replacement disclosure form or use an existing form authorized by a state insurance commission or other regulatory body. Consistent with any state requirements, the appropriate form should be completed for each replacement involving variable life insurance. The form should include the signatures of the customer and the registered representative. Members should provide their registered representatives and registered principals with appropriate procedures on replacements. Members should determine that the proposed replacement transaction is suitable and that the registered representative has complied with firm procedures and applicable state regulations regarding disclosure requirements.

A member should review a variable life insurance application to determine that any replacement question is answered. For example, if questions on whether the proposed policy replaces any existing annuity or policy are not completed, then the registered principal should request that the registered representative obtain a completed application.

The member may create a compliance report that tracks replacement activity by each registered representative. Replacement activity exceeding a certain percentage of the registered representative's total activity could trigger further review. The member may also decide to design a compliance system to flag unacknowledged replacement activity by utilizing background information such as surrenders, reduced face amounts, lapses, and modified surrenders. To assist in this review, a member could use quarterly 1035 exchange reports or other reports that may be provided by a number of insurance companies. Upon reasonable request and to the extent practical, wholesale members should also assist retail broker/dealers in monitoring the replacement activity of their customers.

E. Life Insurance Financing

Members should not recommend that a customer finance a variable life insurance policy from the value of another life insurance policy or annuity, such as through the use of loans or cash values, unless the transaction is otherwise suitable for the customer. The NASD believes that the burden of demonstrating that such financed transactions are in the customer's best interests would generally be more difficult than for a routine sale of variable life insurance. In the *Pruco* case, many customers' existing cash values were depleted to pay the premiums of new policies. The new policies lapsed when the required premium for the new variable life insurance policy exceeded the dividend stream or cash value of the original policy.

When financing is recommended, registered representatives should disclose to the 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 acknowledgment, the registered representative's signature, and a registered principal's signature.

Members should monitor these arrangements so that they can prevent improper and excessive financed and replacement sales. For internalized activity, members could create a system that matches new policies with disbursements from existing policies for a set time period and track that activity. Members should consider whether to vary review and report periods in order to prevent registered representatives from timing financed or replaced transactions to escape detection.

F. Advertising And Sales Literature

Under NASD Rule 2210, members must file with NASD Regulation's Advertising/Investment Companies Regulation Department all variable life insurance advertisements and sales literature within 10 days of first use or publication. Members are also required to file the format for hypothetical illustrations used in the promotion of variable life insurance policies, since these formats qualify as sales literature. Members must have supervisory procedures in place to ensure compliance with the rule's filing requirements. Members also must ensure that all advertisements and sales literature regarding variable life insurance are approved in writing by a registered principal and prior to use with the public.

Any communication discussing the tax-deferral benefits of variable life insurance should not obscure or diminish the importance of the life insurance features of the product. Any variable life insurance communication that overemphasizes the investment aspects of the policy or potential performance of the subaccounts may be misleading.

G. Members' Supervisory Systems And Procedures

Notice to Members 99-45 (June 1999) provides guidance on member supervisory procedures. The *Notice* emphasizes that NASD Rule 3010 require members, regardless of their size or complexity, to adopt and implement a supervisory system that is tailored specifically to a member's business. Supervisory systems must address the activities of all of the member's registered representatives and associated persons and may include components such as automated exception reports and surveillance programs that monitor unusual activity. Members must adopt written supervisory procedures that document the supervisory system and that are reasonably designed to achieve compliance with all applicable securities laws and regulations and NASD rules.

Members may wish to design their own supervisory system to monitor variable life insurance sales activities based upon the member's organization and structure. For some members with geographically dispersed offices and personnel, a decentralized supervisory system may be sufficient. For other members, a centralized compliance supervisory system may be more appropriate.

Members should design systems that provide an easy and expeditious way for customers to communicate complaints, and that ensure that customer complaints are acted upon, analyzed, and researched.

Endnote

[1]Letter of Acceptance, Waiver and Consent No. CAF990010 (July 8, 1999).

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