

# Notice to Members

AUGUST 2006

## SUGGESTED ROUTING

Internal Audit  
Legal and Compliance  
Retail  
Senior Management

## KEY TOPICS

Variable Life Settlements  
Variable Insurance Policies  
Suitability  
Best Execution  
Rule 3010

## GUIDANCE

### Life Settlements

#### Member Obligations with Respect to the Sale of Existing Variable Life Insurance Policies to Third Parties

#### Executive Summary

Sales of existing life insurance policies to third parties—often referred to as "life settlements"—have grown exponentially in recent years, and that trend appears likely to continue. The purpose of this *Notice* is to remind firms and associated persons that life settlements involving variable insurance policies are securities transactions, and firms and associated persons involved in such transactions are subject to applicable NASD rules.

#### Questions

Questions regarding this *Notice* may be directed to Eric Moss, Vice President and Director of Emerging Regulatory Issues, at (202) 728-8982; or Laura Gansler, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8275.

#### Background and Discussion

Until recently, the owner of a life insurance policy who no longer wanted or could not afford it had two options: to let it lapse or surrender it to the issuer for its cash surrender value. The emergence of a secondary market for existing life insurance policies provides a third alternative: to sell the policy to a third party for less than the net death benefit, but more than the cash surrender value. Such transactions are typically referred to as life settlements. The value of a particular life settlement depends on a variety of factors, including the insured's life expectancy and the nature and terms of the policy.

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The life settlement market emerged as an offshoot of the viatical settlement industry that developed in the 1980s as a source of liquidity for AIDS patients and other terminally ill policyholders with life expectancies of less than two years. Unlike viaticals, however, life settlements involve policyholders who are not terminally ill, but generally have a life expectancy of between two and ten years. Life settlements also tend to involve policies with higher net death benefits than viaticals.

The life settlement market has expanded rapidly in recent years. One recent study estimates that existing policies with a collective face value of \$5.5 billion were sold by policyholders to investors in 2005, while others suggest that the potential market exceeds \$100 billion. Although business models vary, in a typical scenario, an insured sells an existing policy to a life settlement provider, which either holds it to maturity and collects the net death benefit, or sells the policy or interests in multiple, bundled policies to hedge funds or other investors. The insured may contact the life settlement provider directly, or through a financial adviser, or may use a life settlement broker, which solicits bids from multiple life settlement providers on behalf of the insured. In most states, both life settlement providers and life settlement brokers are subject to licensing and other requirements.

Most life settlement providers claim to target only those policyholders who have already made the decision to surrender a policy or allow it to lapse, either because the policy is no longer wanted or needed, or because the policyholder can no longer afford to pay the premiums. However, as more providers enter the life settlement industry, there is increasing competition to find policyholders who fall into that relatively narrow category. This has led some life settlement providers to aggressively encourage financial service providers, including broker-dealers, to canvass their books of business for seniors or other eligible customers who may be interested in selling their life insurance policies in the secondary market, even if they do not need to or had not previously considered surrendering or allowing their policies to lapse. Significantly, the commissions paid in connection with life settlements are typically quite high—in some cases, up to 30 percent or more of the purchase price. Accordingly, NASD is concerned that aggressive marketing tactics, fueled by high commissions, may lead to inappropriate sales practices in connection with these transactions.

**Obligations under NASD Rules for Firms and Associated Persons When Recommending or Facilitating the Sale of an Existing Variable Life Insurance Policy to Third Parties**

A variable life insurance policy is a security, and the sale of such a product in the secondary market is a securities transaction subject to NASD rules. The purpose of this *Notice* is to remind firms and associated persons of their obligations in connection with recommending or facilitating a variable life settlement, including suitability, due diligence, best execution, supervision and training, and compensation in connection with variable insurance contracts.

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### *Suitability*

NASD Rule 2310 requires that, before recommending the purchase, sale or exchange of a security, members must have a reasonable basis for believing that the transaction is suitable for the customer. This analysis requires an associated person to fully understand and explain to their customers the products and transactions they recommend. This analysis also requires an associated person to make reasonable efforts to obtain information concerning the customer's financial status, tax status, investment objectives and other relevant information.

NASD is concerned that some of the marketing materials prepared by life settlement companies to encourage financial service providers, including broker-dealers, to recommend life settlements to their customers do not present a fair and balanced view of life settlements, and may encourage broker-dealers to recommend unsuitable transactions.

A variable life settlement may be a valuable option for insureds who otherwise would surrender their policies or allow them to lapse. However, variable life settlements are not for everyone. There can be significant costs associated with such transactions, and NASD cautions firms that a variable life settlement is not necessarily suitable for a customer simply because the settlement price offered exceeds the policy's surrender value. Other relevant factors may include the customer's continued need for coverage, and, if the customer plans to replace the existing policy with another policy, the availability, adequacy and cost of comparable coverage. Depending on the circumstances, including the customer's stated financial needs and investment objectives, firms also may need to consider the basic tax and other relevant implications of selling a variable policy.<sup>1</sup>

### *Due Diligence*

In addition to the general due diligence regarding terms and conditions that is required in connection with any securities transaction, the unique nature of variable life settlements poses certain special concerns.<sup>2</sup> Purchasers of life settlements, whether they are life settlement providers, or the entities or investors who purchase interests in life settlements from them, commit to paying the premiums on the policy for the insured's lifetime in exchange for the net death benefit when the insured dies. Therefore, the sooner the insured dies, the more profitable the life settlement is to the purchaser. In sum, the purchaser acquires a financial interest in the insured's death.

While some states require that life settlement providers and brokers have confidentiality policies in place to protect the identity and the medical records of the insured, others do not. Likewise, some life settlement brokers only solicit bids from providers with such policies; others do not. Before recommending a life settlement to a customer, firms and associated persons should understand the confidentiality policies of the providers or brokers with whom they are doing business. They should also understand and be able to explain to their customers any ongoing obligations the customer will incur. For example, some life settlement providers require that the insured provide notification of significant medical developments.

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Given the wide range of practices among industry participants, as well as the regulatory disparity among the states, firms that allow their associated persons to recommend variable life settlements may want to consider developing a list of approved life settlement providers and/or brokers whose policies and practices are consistent with the firms' obligations to its customers. At a minimum, NASD believes that firms should prohibit their associated persons from recommending variable life settlements that involve life settlement providers and brokers that are not properly licensed where such licenses are required.

#### *Best Execution*

Firms recommending or facilitating a variable life settlement must also make certain that they meet their best execution obligations under NASD Rule 2320. How that obligation is met in any given transaction depends on the particular facts and circumstances of the transaction, but the core duty is to use reasonable diligence first to ascertain the best market for the security, and then to obtain the most favorable price possible in that market under prevailing market conditions. Price is only one component of best execution. Other factors include the speed and quality of execution, and the reliability of the other market participants. Firms must develop their own policies and procedures for ensuring best execution in the context of variable life settlements. At a minimum, however, NASD believes that firms recommending that a customer sell a variable life insurance policy should make reasonable efforts to obtain bids from multiple licensed providers, either directly or through a life settlement broker.<sup>3</sup> Therefore, an exclusivity arrangement between a firm or an associated person and one life settlement provider would generally be inconsistent with the firm's best execution obligations. Moreover, in a market that is evolving as rapidly as the life settlement market, firms should regularly review their best execution policies and procedures to ensure that they continue to satisfy Rule 2320.<sup>4</sup>

#### *Training and Supervision*

In accordance with NASD Rule 3010, members should establish an appropriate supervisory system to ensure that their associated persons comply with all applicable NASD and SEC rules when recommending or participating in the sale of variable life insurance policies in the secondary market. Among other things, firms must ensure that their written supervisory procedures require that the appropriate reasonable-basis suitability analysis is completed before transactions are recommended; associated persons perform appropriate customer-specific suitability analysis; all promotional materials are accurate and balanced; and all NASD and SEC rules are followed. In addition to establishing written procedures, firms also must document the steps they have taken to ensure adherence to these procedures.

Firms and associated persons should also remember that, pursuant to NASD Rule 3040, to the extent that an associated person participates in a settlement involving a variable life insurance policy outside the regular course or scope of the associated person's employment with a member, the associated person must provide prior written notice to the member describing the proposed transaction in detail. If the associated person is to

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receive compensation in connection with the transaction, the member firm must approve in writing the associated person's participation in the transaction, must record it on the firm's books and records and must supervise the person's participation as if the transaction were executed on behalf of the member.

#### *Compensation in Connection with Variable Insurance Contracts*

NASD also reminds members that Rule 2820(g), governing the sale and distribution of variable contracts, prohibits an associated person from accepting any compensation from anyone other than the member with which the person is associated except in the manner specified by the rule. Members therefore should ensure that any compensation received by associated persons in connection with recommendations to sell a variable life insurance policy comports with this rule.

#### **Participation in the Subsequent Marketing and Sale of Interests in Life Settlements**

While this *Notice* focuses primarily on the obligations of NASD members and associated persons when recommending that a customer sell an existing variable life insurance policy to a third party, NASD is also concerned about the involvement of NASD members and associated persons in the subsequent marketing and sale of interests in life insurance policies for investment purposes. NASD notes that, depending on the circumstances, entities participating in the sale and marketing of interests in life insurance policies, variable or not, for investment purposes may trigger broker-dealer registration requirements under the Securities Exchange Act of 1934. NASD will continue to monitor this emerging market closely, and will take appropriate action or issue further guidance as necessary.

#### **Endnotes**

- 1 NASD notes that the sale of a variable policy, under certain circumstances, could have the unintended consequence of affecting the customer's eligibility for Medicaid or other federal programs
- 2 NASD has routinely reminded members about their due diligence obligations when recommending any securities transaction. See, e.g., *NASD Notice to Members 03-71: NASD Reminds Members of Obligations When Selling Non-Conventional Investments* (Nov. 2003).
- 3 If multiple bids from licensed providers are not available, firms may perform or obtain an actuarial valuation as a means to comport with their best execution responsibilities in terms of the price being offered.
- 4 For the sake of clarity, NASD reiterates that this *Notice* is aimed at the sale of existing variable life insurance policies by the insured to a third party, and nothing in the discussion of best execution obligations is meant to suggest that members are required to recommend the lowest-cost product when recommending the initial purchase of a variable insurance policy from an issuer.

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