

## Variable Life Settlement Transactions

### FINRA Reminds Firms of Their Obligations With Variable Life Settlement Activities

#### Executive Summary

Sales of existing life insurance policies to third parties—referred to as life settlements—have increased in recent years and the trend appears likely to continue. FINRA is concerned about variable life settlements because they involve materially different factors and raise materially different issues than more widely held securities such as stocks or bonds. Additionally, firms' marketing of variable life settlements is directed almost exclusively toward senior investors who, concerned about current economic conditions and retirement, may consider selling their variable life insurance policies without fully appreciating the risks and costs of variable life settlements.

FINRA reminds firms that:

- ▶ variable life settlements are securities transactions that are subject to the federal securities laws and all applicable FINRA rules;
- ▶ if they seek to enter the business of variable life settlements, they must file an application for approval of this material change in business under NASD Rule 1017;
- ▶ they must present balanced and fair information in their advertising and other communications with the public and customers about variable life settlements and related products,<sup>1</sup> and otherwise comply with all aspects of NASD Rule 2210; and
- ▶ they must adhere to suitability obligations under NASD Rule 2310; fair and reasonable commissions under FINRA Rule 2010 (formerly NASD Rule 2110), NASD Rule 2440 and related guidance; and fair fees and the disclosure of fees under NASD Rule 2430.

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#### Notice Type

- ▶ Guidance

#### Suggested Routing

- ▶ Advertising
- ▶ Compliance
- ▶ Legal
- ▶ Registered Representatives
- ▶ Senior Management
- ▶ Variable Contracts

#### Key Topics

- ▶ Communications with the Public
- ▶ Commissions
- ▶ Fees
- ▶ Membership Rules
- ▶ Suitability
- ▶ Variable Insurance Policies
- ▶ Variable Life Settlements

#### Referenced Rules & Notices

- ▶ FINRA Rule 2010
- ▶ NASD Rule 1017
- ▶ NASD Rule 2210
- ▶ NASD Rule 2310
- ▶ NASD Rule 2430
- ▶ NASD Rule 2440
- ▶ NASD IM-2440-1
- ▶ NTM 75-65
- ▶ NTM 00-73
- ▶ NTM 03-71
- ▶ NTM 05-26
- ▶ NTM 06-38
- ▶ Regulatory Notice 07-43
- ▶ Regulatory Notice 08-57
- ▶ SEA Rule 10b-5

Questions concerning this *Notice* should be directed to:

- Lawrence Kosciulek, Director, Investment Companies Regulation, at (240) 386-4535;
- Matthew E. Vitek, Counsel, Office of General Counsel (OGC), at (202) 728-8156 (regarding membership); or
- Sharon Zackula, Associate Vice President and Associate General Counsel, OGC, at (202) 728-8985 (regarding compensation).

## Background & Discussion

Current poor economic conditions, volatility in the financial markets and negative economic forecasts have depressed the value of housing and many traditional financial instruments, such as stocks and corporate bonds. Many individual investors, particularly those who are retired or close to retirement, may be concerned about their financial situation. In this economic environment, and at all times, FINRA is concerned that investors may consider selling their variable life insurance policies to obtain additional cash without fully appreciating the risks of variable life settlements, such as:

- unexpected tax liabilities;
- decreased access to insurance coverage, if needed; and
- the release of the individual's private medical information.

In addition, investors may not fully understand the transaction-related costs of selling their variable life insurance policy in a life settlement transaction. Business models differ, but often a number of intermediaries are involved in a single, variable life settlement transaction. In some, the number of intermediaries can result in increased commission charges and additional expenses, which substantially reduce the amount of money the selling investor receives as proceeds from the variable life settlement.<sup>2</sup>

The sale of investment products that are derivative of or based on life settlements — “related products” — is also likely to increase.<sup>3</sup> Transactions in related products are also securities transactions that are subject to the federal securities laws and all applicable FINRA rules. FINRA is also concerned about investors who purchase these related products, as investors may not fully understand the risks of such investments.<sup>4</sup> Retail investors may be attracted to related products that pay a higher yield than conventional investments or, in some cases, guarantee a return by a specific date, without being aware that generally, related products are illiquid investments and an investor may be unable to sell the investment, or may be forced to sell at a steep discount, if the investor needs the funds prior to maturity. Also, the yield on a related product may be adversely affected by the parties structuring the related product — by an inexperienced or incomplete actuarial analysis or an incomplete assessment of the medical conditions of any insured(s) covered by any policy in which an investor has an interest, or by a failure to follow applicable law regarding life settlements that may result in legal challenges at

the time a death benefit is payable.

External developments, such as advances in medical research and treatment regarding certain diseases, also may reduce the yield of related products. In addition, an investor purchasing certain related products, such as a “guaranteed” life settlement—*e.g.*, the investment matures and repayment with interest is guaranteed not later than a specific date, even if the insured person has not passed away—may rely on the creditworthiness of the firm that structured the guaranteed life settlement or of a third-party guarantor whose creditworthiness may be unknown.

### Material Change in Business Operations

*Notice to Members (NTM) 00-73* describes the factors that identify a “material change in business operations.” Among the factors FINRA considers are the relationship, if any, between the proposed new business line and the firm’s existing business, and the degree to which the firm’s existing financial, operational, supervisory and compliance systems can accommodate the proposed new business activity.

Based on these factors, firms should be aware that expansion into business activities related to variable life settlements constitutes a material change in business operations under NASD Rule 1011(k). Therefore, before engaging in variable life settlements, a firm must first file a Continuing Membership Application and receive approval of this change in business operations under NASD Rule 1017. Some of the most important obligations and applicable FINRA rules in connection with variable life settlements are addressed in *NTM 06-38*.<sup>5</sup> In addition, other FINRA Notices provide guidance regarding a firm’s responsibilities and obligations when a firm introduces a new product or buys or sells products that are complex or non-conventional, and the special concerns that are present when marketing a product focused almost exclusively toward senior retail investors.<sup>6</sup>

### Suitability and Disclosure

The unique factors involved in an investor’s decision to enter into a variable life settlement are also the factors that a firm recommending such a transaction must consider when determining, among other things, if the transaction is suitable. In accordance with a firm’s suitability obligation under NASD Rule 2310, a firm recommending a variable life settlement to a customer must determine the necessity and extent of disclosure of those aspects of a life settlement transaction that may be material to a potential seller. A firm may not be in a position to complete its due diligence obligations under the suitability requirement in the absence of disclosure and detailed conversations with solicited customers. Often, the unique particularity of factors determining the suitability of a recommended life settlement transaction are such that disclosure to and detailed conversations with the customer are necessary to

make the due diligence determinations required of firms under the suitability obligation.

There are several financial issues that an investor selling a variable life policy may need to consider. An investor should understand the tax treatment of the cash payment when paid in a variable life settlement as compared to the tax treatment of the death benefit to the beneficiary. Balancing the investor's need for current income with the future financial needs of a survivor also may be an important part of the analysis. An investor should also be aware that a variable life settlement transaction takes a longer time to complete than a typical securities transaction. The investor may need to consider how the sale could affect his or her eligibility for certain public assistance programs, such as Medicaid. The benefits of a sale must be weighed against the transaction-related costs of a variable life settlement, which are often substantial. Also, if an investor needs or desires to obtain replacement life insurance, there should be an understanding and consideration of the impact that the variable life settlement may have on the ability to obtain replacement insurance. If replacement insurance will be sought, there needs to be consideration of the costs of premiums of the policy to be sold compared to a new policy, and the comparability of the coverage.

An investor interested in selling his or her variable life policy in a variable life settlement must provide complete access to the investor's medical history (*e.g.*, all past and current medical conditions, their treatment, all drugs prescribed) and any other information, no matter how personal, that may affect the investor's life expectancy, and must do so without any assurance that the life settlement will occur. This access may be granted to many people, including persons involved in the transaction at the closing, third parties evaluating the transaction, investors and potential investors. Most of these people will never be identified to the investor. Also, the investor may have an on-going obligation to disclose personal information, including his or her general health, new medical conditions and changes in pre-existing conditions, until his or her death. Moreover, the investor should appreciate fully that the buyer has a financial interest in the seller's death.

Consequently, it is FINRA's view that NASD Rule 2310's due diligence component requires, before firms can make a suitability determination, that firms must take appropriate steps to make investors aware of the issues raised above and other pertinent information regarding a variable life settlement. If a firm fails to disclose information that would be viewed as material to a reasonable investor in making a decision to buy or sell a security, or the firm does not present pertinent information clearly, the firm may violate the anti-fraud provisions of the federal securities laws in

addition to FINRA's suitability rule.<sup>7</sup>

### Communications

FINRA understands that advertising and marketing materials and sales campaigns about variable life settlements are directed almost exclusively towards senior investors because their remaining life expectancy provides the potential of an attractive yield to investors. Firms seeking to identify investors who may consider selling their variable life insurance policy to a third party must present balanced, fair and comprehensive information in its advertising and marketing materials and any other communication. Firms, their associated persons and other intermediaries must not use high-pressure sales tactics and other aggressive advertising, marketing and sales efforts. Some investors may be unduly influenced by communications that are overly aggressive, not fair or balanced, or lack important information or disclosures. This may be especially true if an investor is concerned about current cash needs, is under financial pressure because his or her retirement assets have fallen in value or interest income from fixed income securities has been reduced, or the investor is concerned about current or future medical expenses, long-term care or other needs.

NASD Rule 2210 prohibits firms from making any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public. A firm's communications, including those about variable life settlements or related products—whether the firm is acting as a broker soliciting business or a dealer—must be fair and balanced and based on principles of fair dealing and good faith. These obligations may not be waived or met by disclaimer.

New firms that engage in the business of variable life settlements or related products must file their advertisements with FINRA. NASD Rule 2210 requires any firm that has not previously filed advertisements with FINRA to file all of its advertisements at least 10 days prior to first use; this filing requirement continues for one year from the first submission. In addition, all firms must file advertisements and sales literature concerning variable life settlements or related products (involving any variable products) within 10 business days of first use or publication. Finally, NASD Rule 2210's internal approval and recording-keeping provisions apply to communications in connection with variable life settlement or related products activities. The rule requires that a registered principal approve all advertisements and sales literature prior to use, in writing.

### Commissions and Fees

FINRA is concerned that investors selling their variable life policies may be charged excessively high commissions or fees. Under NASD Rule 2440 and IM-2440-1

(collectively, the “commission rules”), a firm is prohibited from charging a customer more than a fair and reasonable commission in any securities transaction, which include variable life settlements and transactions in related products.<sup>8</sup> In addition, under FINRA Rule 2010, a firm that charges an unfair commission violates the firm’s obligation to observe just and equitable principles of trade in the conduct of the firm’s business.<sup>9</sup> Similarly, any fees a firm charges a customer must be reasonable. Under NASD Rule 2430, firms are prohibited from charging unreasonable fees or fees that unfairly discriminate among the firm’s customers for miscellaneous services.<sup>10</sup> In 2006, FINRA discussed variable life settlements and reminded firms and associated persons of their obligations under various FINRA rules, including those related to compensation.<sup>11</sup> At that time, FINRA noted its concern that the lure of very high commissions might lead firms and their associated persons to aggressively market such transactions and engage in other inappropriate sales practices.

FINRA continues to receive questions about the application of the commission rules with regard to variable life settlements. Often these inquiries reflect, in membership applications or other sources, a firm’s intention to charge commissions that exceed, by 100 percent or more, any commission that FINRA historically has considered fair and reasonable. Firms are reminded that although the commission rules do not state specific commission amounts for a variable life settlement or any other security, most securities products are sold for commissions of considerably less than five percent and those in excess of five percent are subject to heightened scrutiny.

Under NASD Rule 2440, the fairness of a commission is determined by the factors set out in the rule. A firm is required to take into consideration all relevant facts and circumstances regarding the transaction, including market conditions with respect to the security, the expense of executing the transaction and the value of the services the firm renders in setting the firm’s commission. A firm should be prepared to justify that its commission is fair as to each customer and transaction.<sup>12</sup>

Additional guidance is provided in NASD IM-2440-1, which applies to commission charges. Some factors that may be relevant are set forth in NASD IM-2440-1(b)(1) through (7) and include:

- the type of security;
- any unusual circumstances connected with the acquisition or sale of a security, including availability of the security in the market;
- the price of a security;
- transactions involving small amounts of money;
- disclosure of the firm’s commission to the customer;

- the firm's pattern of mark-ups; and
- the nature of the firm's business.

Depending on the particular transaction, additional factors may be part of the facts and circumstances to be considered when determining if a commission is fair.

According to some firms, the completion of variable life settlement transactions may take much longer than other securities transactions and include unique costs. Nevertheless, such summary conclusions supporting increased commission costs are not sufficient as a basis; a firm should be prepared to justify and evidence that its commission is fair and reasonable as to each customer and variable life settlement and apply the factors in the commission rules, including those in NASD IM-2440-1(b). Additionally, disclosures of commissions (if made) on a variable life settlement transaction, should be based on the gross offer (the readily available market value of the policy) made to the seller, not the face value of the policy or the net offer.

Firms should understand that:

- the length of time that a transaction takes to complete does not by itself translate into the effort or cost in completing that transaction on the part of the firm;
- the paperwork that a selling investor may need to provide is not necessarily indicative of the firm's effort in completing the transaction;
- the general level of liquidity in the market does not necessarily mean that any particular transaction was difficult or required enhanced efforts to complete;
- the use of interpositioned parties may not necessarily form a basis for higher commission rates, as some firms are able to complete these transactions without such parties; and
- the general level of compensation for such similar transactions outside of the securities industry is not relevant because of the lack of applicability to non-regulated parties of FINRA's fair and reasonable commission rules.

### **Firms Currently Engaged in Life Settlement or Related Products Activity**

Firms that currently engage in variable life settlement or related products business activities must be aware of their obligations under all applicable FINRA rules. As discussed in this *Notice* and *NTM 06-38*, variable life settlements and transactions in related products raise a number of unique regulatory and compliance issues. Among other things, firms must carefully and thoroughly address these issues and other relevant compliance matters in their policies and procedures, and supervision of such transactions and associated persons engaged in such transactions.<sup>13</sup>

## Endnotes

- 1 For the purpose of this *Notice*, “related products” are defined as a security that is an interest in a single life policy, or a group or a pool of such policies, whether variable or not, such as an asset-backed security backed by life insurance policies, or a security where the obligation to pay interest or principal to the holder is contingent or partially contingent upon the death of one or more insured persons under life insurance policies, or a bonded or a guaranteed life settlement security based on one or more policies.  
  
A bonded or guaranteed life settlement security may include the following elements:
  - the maturity of the bond is set at approximately the same time or occurs shortly after the death benefit(s) is expected to be paid under the life insurance policy(ies) that is the reference policy(ies) for the security;
  - the security includes a call, which the issuer may exercise if the issuer receives the death benefit(s) earlier than projected; and
  - if, at maturity, the issuer has not received the death benefit(s), the bondholder(s) will be paid the accrued interest and principal by the issuer, who may look to a bonding entity or a guarantor.
- 2 For purposes of this *Notice*, “commission charges” refers to commissions, commission-equivalents, fees and any other compensation, however named, that a firm charges a customer in a life settlement.
- 3 See endnote 1.
- 4 Generally, the returns or yields to investors on life settlements, including variable life settlements and related products, do not correlate to other investments. During periods when many assets decline in value, there may be more demand for non-correlated investments.
- 5 See *NTM 06-38* (August 2006) (Life Settlements: Member Obligations with Respect to the Sale of Existing Variable Life Insurance Policies to Third Parties).
- 6 See *NTM 05-26* (April 2005) (New Products: NASD Recommends Best Practices for Reviewing New Products); *NTM 03-71* (November 2003) (Non-Conventional Investments); and *Regulatory Notice 07-43* (September 2007) (Senior Investors: FINRA Reminds Firms of Their Obligations Relating to Senior Investors and Highlights Industry Practices to Serve these Customers). In *Regulatory Notice 07-43*, FINRA discusses specific issues (*e.g.*, exhibiting diminished capacity and suspected financial abuse) that firms sometime encounter when dealing with senior investors, including providing guidance about steps that some firms have taken as a matter of sound business practice and as a way of serving their senior customers.
- 7 See NASD Rule 2310 and NASD IM-2310-2; NASD Rule 2120; and Securities Exchange Act Rule 10b-5. Professionals must discuss clearly all issues because some statements, although literally accurate, can become, through their context and manner of presentation, misleading.

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- 8 Under NASD Rule 2440, if a firm charges a customer a commission, the firm shall not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the markets therefore.
- NASD IM-2440-1 provides additional guidance regarding fair and reasonable commissions. A second interpretation to NASD Rule 2440, IM-2440-2, primarily deals with mark-ups and is not included in this discussion.
- 9 FINRA Rule 2010 (formerly NASD Rule 2110) requires a firm to observe high standards of commercial honor and just and equitable principles of trade. NASD Rule 2110 was transferred without change to the new consolidated FINRA rulebook (Consolidated FINRA Rulebook) as FINRA Rule 2010 and became effective on December 15, 2008. *See Regulatory Notice 08-57* (October 2008) (FINRA Announces SEC Approval and Effective Date for New Consolidated FINRA Rules).
- 10 NASD Rule 2430 provides that charges, if any, for services performed, including miscellaneous services such as collection of moneys due for principal, dividends or interest; exchange or transfer of securities; appraisals, safe-keeping or custody of securities, and other services, shall be reasonable and not unfairly discriminatory among customers.
- 11 *See NTM 06-38.*
- 12 *See NTM 75-65* (October 1975).
- 13 *See NTM 06-38.*