

Deferred Variable Annuities

FINRA Reminds Firms of Their Responsibilities Under FINRA Rule 2330 for Recommended Purchases or Exchanges of Deferred Variable Annuities

Executive Summary

FINRA reminds firms of their responsibilities under the new consolidated FINRA rule on deferred variable annuities.¹ The implementation date of the FINRA rule—as well as previously approved amendments to parts of the rule covering principal review and supervisory procedures—is February 8, 2010.² This *Notice* also addresses issues raised about a firm's ability to hold checks made payable to entities other than itself (third parties) pursuant to interpretive relief that FINRA previously issued.³

For easy reference, the text of new FINRA Rule 2330 is set forth in Attachment A.

Questions regarding this *Notice* should be directed to:

- ▶ James S. Wrona, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8270; or
- ▶ Lawrence N. Kosciulek, Director, Investment Companies Regulation, at (240) 386-4535.

Background & Discussion

FINRA Rule 2330 (formerly NASD Rule 2821) establishes sales practice standards regarding recommended purchases and exchanges of deferred variable annuities.⁴ The rule has the following six main sections:

- ▶ General considerations, such as the rule's applicability;
- ▶ Recommendation requirements, including suitability and disclosure obligations;
- ▶ Principal review and approval obligations;

January 2010

Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

Key Topic(s)

- ▶ Deferred Variable Annuities
- ▶ Principal Review
- ▶ Sales Practices
- ▶ Suitability
- ▶ Supervision

Referenced Rules & Notices

- ▶ FINRA Rule 2150
- ▶ FINRA Rule 2320
- ▶ FINRA Rule 2330
- ▶ NASD Rule 2330
- ▶ NASD Rule 2820
- ▶ NASD Rule 2821
- ▶ SEA Rule 15c3-1
- ▶ SEA Rule 15c3-3
- ▶ Regulatory Notice 07-53
- ▶ Regulatory Notice 09-32
- ▶ Regulatory Notice 09-72

- Requirements for establishing and maintaining supervisory procedures;
- Training obligations; and
- Supplementary material that addresses a variety of issues ranging from the handling of customer funds and checks to information gathering and sharing.

As noted above, all of the rule's provisions are applicable as of February 8, 2010.

Recently, questions have been raised regarding FINRA's limited interpretive relief from the requirements of FINRA Rule 2150(a) (formerly NASD Rule 2330(a)) and FINRA Rule 2320(d) (formerly NASD Rule 2820(d)).⁵ The former rule generally prohibits firms from making improper use of customer funds, and the latter requires firms to transmit promptly to issuers applications and purchase payments for variable contracts. FINRA provided limited interpretive relief from these rules to allow firms to perform comprehensive and rigorous reviews of recommended transactions in deferred variable annuities under FINRA Rule 2330.⁶

FINRA originally stated that "a firm may hold an application for a deferred variable annuity and a customer's non-negotiated check payable to an insurance company for up to seven business days without violating either NASD Rule 2330 or 2820 if the reason for the hold is to allow completion of principal review of the transaction pursuant to NASD Rule 2821."⁷ After the SEC approved amendments that changed the starting point for the review period—from the date when the customer signs the application to the date when a firm's office of supervisory jurisdiction (OSJ) receives a complete and correct application package—FINRA explained that its limited interpretive relief "continues to apply even though the triggering event for the principal review period has changed via the recently approved amendments."⁸

Concerns have been expressed, however, regarding the breadth of the interpretive relief and the conditions that must be present for it to apply. FINRA now clarifies that the interpretive relief applies only if the seven conditions delineated below are present.⁹

1. The reason that the firm is holding the application for a deferred variable annuity and/or a customer's non-negotiated check payable to a third party is to allow completion of principal review of the transaction pursuant to FINRA Rule 2330.
2. The associated person who recommended the purchase or exchange of the deferred variable annuity makes reasonable efforts to safeguard the check and to promptly prepare and forward a complete and correct copy of the application package to an OSJ.
3. The firm has policies and procedures in place that are reasonably designed to ensure that the check is safeguarded and that reasonable efforts are made to promptly prepare and forward a complete and correct copy of the application package to an OSJ.

4. A principal reviews and makes a determination of whether to approve or reject the purchase or exchange of the deferred variable annuity in accordance with the provisions of FINRA Rule 2330.
5. The firm holds the application and/or check no longer than seven business days from the date an OSJ receives a complete and correct copy of the application package.
6. The firm maintains a copy of each such check and creates a record of the date the check was received from the customer and the date the check was transmitted to the insurance company or returned to the customer.
7. The firm creates a record of the date when the OSJ receives a complete and correct copy of the application package.

If these seven conditions are not present, FINRA's interpretive relief will not apply and it will enforce FINRA Rules 2150(a) and 2320(d), as appropriate.

Endnotes

- 1 On November 20, 2009, the Financial Industry Regulatory Authority, Inc. (FINRA) filed with the Securities and Exchange Commission (SEC or Commission) a proposed rule change, for immediate effectiveness, to transfer NASD Rule 2821 into the Consolidated FINRA Rulebook, as FINRA Rule 2330, without any substantive changes. *See* Exchange Act Release No. 61122 (December 7, 2009), 74 FR 65816 (December 11, 2009) (File No. SR-FINRA-2009-083); *Regulatory Notice 09-72* (December 2009) (discussing adoption of consolidated FINRA rules, including FINRA Rule 2330 covering deferred variable annuities). The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, *see Information Notice, 3/12/08* (Rulebook Consolidation Process).
- 2 *See* Exchange Act Release No. 61122 (December 7, 2009), 74 FR 65816 (December 11, 2009) (File No. SR-FINRA-2009-083); *Regulatory Notice 09-72* (December 2009) (discussing adoption of consolidated FINRA rules and an operative date for FINRA Rule 2330 of February 8, 2010); Exchange Act Release No. 59772 (April 15, 2009), 74 FR 18419 (April 22, 2009) (Order Approving File No. SR-FINRA-2008-019); *Regulatory Notice 09-32* (June 2009) (announcing SEC approval of amendments to NASD Rule 2821 governing purchases and exchanges of deferred variable annuities and an effective date for those

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Endnotes continued

- amendments of February 8, 2010). FINRA notes that paragraphs (a) (General Considerations), (b) (Recommendation Requirements), and (e) (Training) of NASD Rule 2821 became effective on May 5, 2008. *See Regulatory Notice 07-53* (November 2007).
- 3 *See Regulatory Notice 07-53* (November 2007); *see also Regulatory Notice 09-32* (June 2009).
 - 4 In general, a variable annuity is a contract between an investor and an insurance company, whereby the insurance company promises to make periodic payments to the contract owner or beneficiary, starting immediately (an immediate variable annuity) or at some future time (a deferred variable annuity). *See Joint SEC and NASD Staff Report on Broker-Dealer Sales of Variable Insurance Products* (June 2004), available at www.sec.gov/news/studies/secnasdvp.pdf.
 - 5 *See Regulatory Notice 07-53* (November 2007); *see also Regulatory Notice 09-32* (June 2009).
 - 6 *See Regulatory Notice 07-53* (November 2007); *see also Regulatory Notice 09-32* (June 2009). The SEC previously has noted that “many broker-dealers are subject to lower net capital requirements under SEA Rule 15c3-1 and are exempt from the requirement to establish and fund a customer reserve account under SEA Rule 15c3-3 because they do not carry customer funds or securities.” *See Exchange Act Release No. 56376* (Sept. 7, 2007), 72 FR 52400 (Sept. 13, 2007) (Order Granting Exemption to Broker-Dealers from Requirements in SEA Rules 15c3-1 and 15c3-3 to Promptly Transmit Customer Checks). Although some of these firms receive checks from customers made payable to third parties, the SEC does not deem a firm to be carrying customer funds if it “promptly transmits” the checks to third parties. The SEC has interpreted “promptly transmits” to mean that “such transmission or delivery is made no later than noon of the next business day after receipt of such funds or securities.” *Id.* at 52400.
- The SEC provided a conditional exemption for broker-dealers from any additional requirements of Rules 15c3-1 and 15c3-3 due solely to a failure to promptly transmit a check made payable to an insurance company for the purchase of a deferred variable annuity product by noon of the business day following the date the broker-dealer receives the check from the customer, provided (i) the transaction is subject to the principal review requirements of NASD Rule 2821 and a registered principal has reviewed and determined whether he or she approves of the purchase or exchange of the deferred variable annuity within seven business days in accordance with that rule; (ii) the broker-dealer promptly transmits the check no later than noon of the business day following the date a registered principal reviews and determines whether he or she approves of the purchase or exchange of the deferred variable annuity; and (iii) the broker-dealer maintains a copy of each such check and creates a record of the date the check was received from the customer and the date the check was transmitted to the insurance company if approved, or returned to the customer if rejected. *Id.* at 52400. In its order approving recent amendments, the SEC explained that the exemption order continues to apply, notwithstanding the new starting point for the principal review period under NASD Rule 2821. *See Exchange Act Release No. 59772* (April 15, 2009), 74 FR 18419, at 18422 n.37 (April 22, 2009) (Order Approving File No. SR-FINRA-2008-019).

Endnotes continued

- 7 *Regulatory Notice 07-53* (November 2007).
- 8 *Regulatory Notice 09-32* (June 2009).
- 9 FINRA emphasizes that firms are not required to collect and hold checks or funds prior to principal review and approval. A firm may elect to wait until after a principal approves the transaction to collect the check or funds for a deferred variable annuity. Moreover, in accordance with Supplementary Material .03 under FINRA Rule 2330, a firm can forward a check made payable to the insurance company or, if the firm is fully subject to SEA Rule 15c3-3, transfer “funds for the purchase of a deferred variable annuity to the insurance company prior to the member’s principal approval of the deferred variable annuity, as long as the member fulfils the following requirements: (a) the member must disclose to the customer the proposed transfer or series of transfers of the funds and (b) the member must enter into a written agreement with the insurance company under which the insurance company agrees that, until such time as it is notified of the member’s principal approval and is provided with the application or is notified of the member’s principal rejection,

it will (1) segregate the member’s customers’ funds in a ‘Special Account for the Exclusive Benefit of Customers’ (set up as described in SEA Rules 15c3-3(k)(2)(i) and 15c3-3(f)) to ensure that the customers’ funds will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the member, insurance company, or bank where the insurance company deposits such funds or any creditor thereof or person claiming through them and hold those funds either as cash or any instrument that a broker or dealer may deposit in its Special Reserve Account for the Exclusive Benefit of Customers, (2) not issue the variable annuity contract prior to the member’s principal approval, and (3) promptly return the funds to each customer at the customer’s request prior to the member’s principal approval or upon the member’s rejection of the application.”

Attachment A

Text of FINRA Rule 2330

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2000. DUTIES AND CONFLICTS

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2300. SPECIAL PRODUCTS

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2330. Members' Responsibilities Regarding Deferred Variable Annuities

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(a) General Considerations

(1) Application

This Rule applies to recommended purchases and exchanges of deferred variable annuities and recommended initial subaccount allocations. This Rule does not apply to reallocations among subaccounts made or to funds paid after the initial purchase or exchange of a deferred variable annuity. This Rule also does not apply to deferred variable annuity transactions made in connection with any tax-qualified, employer-sponsored retirement or benefit plan that either is defined as a "qualified plan" under Section 3(a)(12)(C) of the Exchange Act or meets the requirements of Internal Revenue Code Sections 403(b), 457(b), or 457(f), unless, in the case of any such plan, a member or person associated with a member makes recommendations to an individual plan participant regarding a deferred variable annuity, in which case the Rule would apply as to the individual plan participant to whom the member or person associated with the member makes such recommendations.

(2) Creation, Storage, and Transmission of Documents

For purposes of this Rule, documents may be created, stored, and transmitted in electronic or paper form, and signatures may be evidenced in electronic or other written form.

(3) Definitions

For purposes of this Rule, the term “registered principal” shall mean a person registered as a General Securities Sales Supervisor (Series 9/10), a General Securities Principal (Series 24) or an Investment Company Products/Variable Contracts Principal (Series 26), as applicable.

(b) Recommendation Requirements

(1) No member or person associated with a member shall recommend to any customer the purchase or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to believe

(A) that the transaction is suitable in accordance with NASD Rule 2310 and, in particular, that there is a reasonable basis to believe that

(i) the customer has been informed, in general terms, of various features of deferred variable annuities, such as the potential surrender period and surrender charge; potential tax penalty if customers sell or redeem deferred variable annuities before reaching the age of 59½; mortality and expense fees; investment advisory fees; potential charges for and features of riders; the insurance and investment components of deferred variable annuities; and market risk;

(ii) the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit; and

(iii) the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity, and riders and similar product enhancements, if any, are suitable (and, in the case of an exchange, the transaction as a whole also is suitable) for the particular customer based on the information required by paragraph (b)(2) of this Rule; and

(B) in the case of an exchange of a deferred variable annuity, the exchange also is consistent with the suitability determination required by paragraph (b)(1)(A) of this Rule, taking into consideration whether

(i) the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living, or other contractual benefits), or be subject to increased fees or charges (such as mortality and expense fees, investment advisory fees, or charges for riders and similar product enhancements);

(ii) the customer would benefit from product enhancements and improvements; and

(iii) the customer has had another deferred variable annuity exchange within the preceding 36 months.

The determinations required by this paragraph shall be documented and signed by the associated person recommending the transaction.

(2) Prior to recommending the purchase or exchange of a deferred variable annuity, a member or person associated with a member shall make reasonable efforts to obtain, at a minimum, information concerning the customer's age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, investment time horizon, existing assets (including investment and life insurance holdings), liquidity needs, liquid net worth, risk tolerance, tax status, and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers.

(3) Promptly after receiving information necessary to prepare a complete and correct application package for a deferred variable annuity, a person associated with a member who recommends the deferred variable annuity shall transmit the complete and correct application package to an office of supervisory jurisdiction of the member.

(c) Principal Review and Approval

Prior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing, but no later than seven business days after an office of supervisory jurisdiction of the member receives a complete and correct application package, a registered principal shall review and determine whether he or she approves of the recommended purchase or exchange of the deferred variable annuity.

A registered principal shall approve the recommended transaction only if he or she has determined that there is a reasonable basis to believe that the transaction would be suitable based on the factors delineated in paragraph (b) of this Rule.

The determinations required by this paragraph shall be documented and signed by the registered principal who reviewed and then approved or rejected the transaction.

(d) Supervisory Procedures

In addition to the general supervisory and recordkeeping requirements of NASD Rules 3010, 3012, and 3110, and Rule 3130, a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule. The member also must (1) implement surveillance procedures to determine if any of the member's associated persons have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of this Rule, other applicable FINRA rules, or the federal securities laws ("inappropriate exchanges") and (2) have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges.

(e) Training

Members shall develop and document specific training policies or programs reasonably designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of this Rule and that they understand the material features of deferred variable annuities, including those described in paragraph (b)(1)(A)(i) of this Rule.

• • • **Supplementary Material:** -----

.01 Depositing of Funds by Members Prior to Principal Approval. Under Rule 2330, a member that is permitted to maintain customer funds under SEA Rules 15c3-1 and 15c3-3 may, prior to the member's principal approval of the deferred variable annuity, deposit and maintain customer funds for a deferred variable annuity in an account that meets the requirements of SEA Rule 15c3-3.

.02 Treatment of Lump-Sum Payment for Purchases of Different Products. If a customer provides a member that is permitted to hold customer funds with a lump sum or single check made payable to the member (as opposed to being made payable to the insurance company) and requests that a portion of the funds be applied to the purchase of a deferred variable annuity and the rest of the funds be applied to other types of products, Rule 2330 would not prohibit the member from promptly applying those portions designated for purchasing products other than a deferred variable annuity to such use. A member that is not permitted to hold customer funds can comply with such requests only through its clearing firm that will maintain customer funds for the intended deferred variable annuity purchase in an account that meets the requirements of SEA Rule 15c3-3. In such circumstances, the checks would need to be made payable to the clearing firm.

.03 Forwarding of Checks/Funds to Insurer Prior to Principal Approval. Rule 2330 does not prohibit a member from forwarding a check made payable to the insurance company or, if the member is fully subject to SEA Rule 15c3-3, transferring funds for the purchase of a deferred variable annuity to the insurance company prior to the member's principal approval of the deferred variable annuity, as long as the member fulfills the following requirements: (a) the member must disclose to the customer the proposed transfer or series of transfers of the funds and (b) the member must enter into a written agreement with the insurance company under which the insurance company agrees that, until such time as it is notified of the member's principal approval and is provided with the application or is notified of the member's principal rejection, it will (1) segregate the member's customers' funds in a bank in an account equivalent to the deposit of those funds by a member into a "Special Account for the Exclusive Benefit of Customers" (set up as described in SEA Rules 15c3-3(k)(2)(i) and 15c3-3(f)) to ensure that the customers' funds will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the member, insurance company, or bank where the insurance company deposits such funds or any creditor thereof or person claiming through them and hold those funds either as cash or any instrument that a broker or dealer may deposit in its Special Reserve Account for the Exclusive Benefit of Customers, (2) not issue the variable annuity contract prior to the member's principal approval, and (3) promptly return the funds to each customer at the customer's request prior to the member's principal approval or upon the member's rejection of the application.

.04 Forwarding of Checks/Funds to IRA Custodian Prior to Principal Approval. A member is not prohibited from forwarding a check provided by the customer for the purpose of purchasing a deferred variable annuity and made payable to an IRA custodian for the benefit of the customer (or, if the member is fully subject to SEA Rule 15c3-3, funds) to the IRA custodian prior to the member's principal approval of the deferred variable annuity transaction, as long as the member enters into a written agreement with the IRA custodian under which the IRA custodian agrees (a) to forward the funds to the insurance company to complete the purchase of the deferred variable annuity contract only after it has been informed that the member's principal has approved the transaction and (b), if the principal rejects the transaction, to inform the customer, seek immediate instructions from the customer regarding alternative disposition of the funds (e.g., asking whether the customer wants to transfer the funds to another IRA custodian, purchase a different investment, or provide other instructions), and promptly implement the customer's instructions.

.05 Gathering of Information Regarding Customer Exchanges. Rule 2330 requires that the member or person associated with a member consider whether the customer has had another deferred variable annuity exchange within the preceding 36 months. Under this provision, a member or person associated with a member must determine whether the customer has had such an exchange at the member and must make reasonable efforts to ascertain whether the customer has had an exchange at any other broker-dealer within the preceding 36 months. An inquiry to the customer as to whether the customer has had an exchange at another broker-dealer within 36 months would constitute a "reasonable effort" in this context. Members shall document in writing both the nature of the inquiry and the response from the customer.

.06 Sharing of Office Space and/or Employees. Rule 2330 requires principal review and approval "[p]rior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing...." In circumstances where an insurance company and its affiliated broker-dealer share office space and/or employees who carry out both the principal review and the issuance process, FINRA will consider the application "transmitted" to the insurance company only when the broker-dealer's principal, acting as such, has approved the transaction, provided that the affiliated broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer.

.07 Sharing of Information. Rule 2330 does not prohibit using the information required for principal review and approval in the issuance process, provided that the broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer. For instance, the rule does not prohibit a broker-dealer from inputting information used as part of its suitability review into a shared database (irrespective of the media used for that database, i.e., paper or electronic) that the insurance company uses for the issuance process, provided that the broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer.

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