

Pension Income Stream Products

FINRA Provides Guidance on Firm Responsibilities for Sales of Pension Income Stream Products

Executive Summary

This *Notice* addresses the responsibilities of firms to supervise the sale of pension income stream products by their associated persons.

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Background and Discussion

Pension income stream products typically involve an up-front lump sum payment to a pensioner in exchange for the rights to the pensioner's future pension income payments.¹ This *Notice* discusses the characteristics of and investor protection issues presented by pension income stream products, as well as the legal status of these products. In addition, this *Notice* addresses the responsibilities of firms in supervising the sale of pension income stream products.

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Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Registered Representatives
- ▶ Senior Management

Key Topics

- ▶ Pension Income Streams
- ▶ Principal Review
- ▶ Sales Practices
- ▶ Suitability
- ▶ Supervision

Referenced Rules & Notices

- ▶ FINRA Rule 3110
- ▶ FINRA Rule 3270
- ▶ FINRA Rule 3280

Pension Income Stream Products

Contracts for pension income stream products involve at least three parties: the pensioner selling the rights to his or her future pension income payments, the investor who pays the up-front lump sum amount to acquire the rights to the pensioner's future payments, and a pension purchasing company, sometimes referred to as a factoring company or pension advance company, that facilitates the sale. Pension income stream products are marketed and advertised to the general public. Moreover, pension purchasing companies may use firms and their associated persons to sell these products to investors. In this event, the sales are subject to applicable FINRA rules.

A typical transaction involves the pension purchasing company collecting information about and evaluating the pensioner and his or her pension. An associated person of a firm may be involved in soliciting investors for the products. The pension purchasing company estimates the lump sum amount that the pensioner will receive from the investor and the monthly amounts that the pensioner will pay to the investor in return.

To facilitate the transfer of funds, the pension purchasing company may establish a bank account or escrow account from which the pensioner receives the lump sum amount and in which the pensioner deposits the future monthly payment amounts. In addition, the investor may deposit the lump sum amount into, and receive the monthly payments from, that same bank or escrow account. A pensioner may also be required to obtain a life insurance policy to cover the outstanding balance due on the contract in the event of the pensioner's death before full payment of the amount due to the investor under the contract.² The pension purchasing company's fees, any life insurance policy premiums and any other applicable fees or commissions, including commissions received by an associated person, are deducted from the lump sum amount paid to the pensioner.

Federal laws prohibit the assignment of particular pension benefits.³ As such, a pensioner does not typically directly assign future pension payments to an investor and instead is bound to make the future payments to the investor only by contract. Because a pensioner may stop making monthly payments at any time, leaving the investor with only a breach of contract claim, the pension purchasing company may also engage in post-sale efforts to ensure payment by the pensioner of the amounts due to the investor. Post-sale efforts by the company may include offering to advance payments to the investor until issues can be resolved, purchasing the product back from the investor, less any payments received by the investor, or engaging the services of a law firm to attempt remediation.

Investor Protection Issues Presented by Pension Income Stream Products

Pension income stream products are complex, and they potentially present a number of investor protection issues. While the expected yields for pension income stream products may initially seem like an attractive option for investors, investors may not fully understand the issues presented by the products. For example, investors may pay significant commissions (*e.g.*, 7 percent or higher) to purchase the products. In addition, the products are generally illiquid, meaning an investor needing funds may not be able to sell the product or may be able to sell the product only at a loss. Furthermore, as noted above, because federal laws prohibit the assignment of particular pension benefits,⁴ a pensioner does not typically directly assign future pension payments to an investor and instead is bound to make the future payments to the investor only by contract. As a result, if a pensioner stops making monthly payments at any time, an investor may be left with only a breach of contract claim. Notwithstanding these and other risks, a U.S. Government Accountability Office (GAO) report indicates that some pension income stream products are marketed as “safe” investments that pay more than other fixed-rate investments without the “downside risks” of stocks, bonds and mutual funds, and use terms that incorrectly imply that the products are backed by the federal government.⁵

The products also may be problematic for pensioners. For instance, pension purchasing companies may not clearly disclose the costs and terms of the product, including associated fees or the real difference between the lump sum that will be paid to the pensioner versus the value of the future income stream the pensioner is giving up (sometimes referred to as the pensioner’s effective interest rate for the lump sum payment).⁶ Moreover, a company may present confusing offer terms thereby making it difficult to understand the product. For example, the GAO Report notes that one company provided a quote including 63 different offers with varying terms and monthly payment amounts to one fictitious pensioner.⁷ In addition, pensioners may not understand that they may be required to obtain a life insurance policy and that the payments for the policy are subtracted from the lump sum payment.

The GAO Report highlights other investor-protection concerns involving this product. Pension purchasing companies may attempt to circumvent federal and state laws by asserting that the product is neither a security nor a loan.⁸ Companies may assert that the products are not securities so as to avoid the registration and disclosure requirements of federal and state securities laws. At the same time, companies may avoid calling the products loans so as to avoid making required truth-in-lending disclosures and to avoid complying with usury laws setting a legal limit on the interest rates and finance charges that may be imposed for some types of loans.⁹ While the companies may assert that a product is neither a security nor a loan, the companies do not offer any alternative legal status for the product thereby leaving pensioners and investors without a clear legal recourse.

Furthermore, certain pension purchasing companies have changed their names or moved the location of their business operations in response to governmental investigations and litigation. Companies may also operate under more than one name.¹⁰ These activities result in associated persons, pensioners and investors having limited publicly available information when evaluating transactions with the companies.

In addition to the GAO Report, FINRA and the SEC have previously issued alerts warning pensioners and investors of the risks associated with these products.¹¹ For further discussion of investor protection issues, individuals are urged to consider these alerts prior to entering into transactions related to pension income stream products.

Status of Pension Income Stream Products

As noted above, pension purchasing companies may attempt to circumvent federal and state laws by asserting that a pension income stream product is not a security. However, FINRA reminds firms that they have an obligation to independently assess whether a product is a security, particularly when determining how to treat an associated person's participation in the sale of such a product away from the firm, discussed further below in the next section. This is critical regarding a product such as a pension income stream product, which is marketed and sold to the general public and exhibits many characteristics of a security under recent case law.

Investors in pension income stream products enter into a contract that entitles them to a fixed return during the term of the contract in exchange for an up-front investment of money. The Securities Act of 1933 defines a "security" to include an investment contract.¹² In its most recent decision on investment contracts, the U.S. Supreme Court held in *SEC v. Edwards*,¹³ among other things, that an investment scheme involving distinct contracts with a contractual entitlement to a fixed rate of return can be an investment contract, and thus a security, under the federal securities laws.¹⁴ In addition, in an administrative proceeding, the SEC held that a product similar to pension income stream products was a security.¹⁵ In that case, an online lending platform connected individuals who wished to borrow money with individuals or institutions that wished to purchase loans extended to borrowers. The online lending platform also performed certain pre- and post-sale functions.¹⁶ The SEC concluded that the notes offered by the online lending platform were securities. Finally, a number of states have determined that pension income stream products are securities under relevant state laws.¹⁷

In the end, whether a particular pension income stream product is a security is dependent on the facts and circumstances specific to that product. However, a firm that treats a pension income stream product as a non-security product risks violating FINRA rules that impose specific obligations on securities activities if the pension income stream product is deemed a security.

FINRA Reminds Firms of Their Obligations Regarding Pension Income Stream Products

FINRA is aware that, in assessing an associated person's pension income stream activities away from the firm, some firms previously have not treated the products as securities for purposes of the applicability of FINRA Rule 3280 (Private Securities Transactions of an Associated Person) and have treated them instead as outside business activities under FINRA Rule 3270 (Outside Business Activities of Registered Persons). A firm is required to evaluate a proposed activity to determine whether it is properly characterized as an outside business activity under Rule 3270 or whether it should be treated as a private securities transaction under Rule 3280.

FINRA Rule 3270 requires a registered person to provide written notice to his or her firm prior to participating in an outside business activity subject to the rule. The firm must consider whether the proposed outside business activity will interfere with or otherwise compromise the registered person's responsibilities to the firm or its customers or be viewed by customers or the public as part of the firm's business. The firm must then consider imposing specific conditions or limitations on the outside business activity, including, where circumstances warrant, prohibiting the activity. The rule, however, does not require that a firm supervise the outside business activity.

In contrast, if a pension income stream product is a security and an associated person sells the product outside the regular scope of his or her employment with the firm, FINRA Rule 3280 requires that the firm treat the sale as a private securities transaction. The associated person must notify the firm in writing before participating in a private securities transaction. If the associated person will receive selling compensation, which is defined broadly, for his or her participation in the transaction, the firm must provide written approval or disapproval of the participation. If the firm approves the transaction, it must record the transaction on its books and records and supervise the associated person's participation in the transaction, including for compliance with suitability standards for recommended securities, as if the transaction were executed on behalf of the firm.¹⁸

There are significant consequences if a firm incorrectly treats a pension income stream product as not being a security. For instance, the firm may incorrectly treat it as an outside business activity under FINRA Rule 3270, rather than a private securities transaction under FINRA Rule 3280, and thereby fail to supervise sales of the product as required by FINRA rules.¹⁹ The firm may also violate FINRA's qualification and registration requirements if associated persons engaged in the marketing and sale of pension income stream products are not appropriately qualified and registered (*e.g.*, registered as a General Securities Representative) to engage in such activities.

Supervisory Measures

Due to potential investor protection issues and regulatory violations that may arise in the marketing and sale of pension income stream products, firms that permit their associated persons to participate in the sale of pension income stream products are well advised to adopt special procedures and training of associated persons with respect to the products.

In developing any special procedures or training, it is important for associated persons to understand the features of these types of products and the extent to which a particular product meets the needs of a customer. Because these products are complex and offer terms vary, an associated person's general familiarity with these types of products may not adequately qualify him or her to understand the specific terms and features of a particular product. FINRA also notes that firms may elect to prohibit the sale of all pension income stream products or maintain a list of those that they find acceptable for their associated persons to market or sell.

In addition, firms should ensure that their procedures comply with applicable state securities laws regarding pension income stream products. As emphasized above, a number of state securities regulators have found that pension income stream products are securities under state securities laws.

As in all other areas, FINRA expects each associated person to comply with the procedures adopted by his or her firm regarding pension income stream products.

Endnotes

1. These types of products may be referred to by one of several names, such as pension loans, pension advances, pension sales, pension income programs, mirrored pensions or annuity utilization contracts. Moreover, the pensioner may have a pension or defined benefit plan related to employment with a private company, the federal government or a state government. Retired members of the military and government employees are the most common pensioners approached for these types of products. For brevity, these types of products are referred to herein as "pension income stream products."
2. See, e.g., GAO, Report to the Committee on Health, Education, Labor, and Pensions, U.S. Senate, [Pension Advance Transactions: Questionable Business Practices Identified](#), at 6-7 (June 2014) (GAO Report).
3. See, e.g., *id.* at 9.
4. See, e.g., *id.*
5. *Id.* at 22.
6. See, e.g., John F. Wasik, [Reading the Fine Print on Pension Advance Agreements](#), The New York Times (December 12, 2014) (noting that the profiled pensioner's cost for the product was the equivalent of an annual rate of 30.7 percent).
7. See, e.g., GAO Report at 30.
8. See, e.g., *id.* at 28-32.
9. FINRA notes that in August 2015, the Consumer Financial Protection Bureau (CFPB) and the Superintendent of Financial Services for the State of New York filed a complaint in a California federal district court asserting that a

- pension income stream product was a loan and, therefore, was subject to the CFPB's jurisdiction. In February 2016, the parties stipulated and agreed to a preliminary injunction order without a finding by the federal district court of fact or law on the status of the pension income stream product. *See CFPB v. Pension Funding, LLC*, Compl. Filed Aug. 20, 2015, Case No. 8:15-cv-1329 (C.D. Cal.).
10. *See, e.g.*, GAO Report at 15.
 11. *See* FINRA and SEC, [*Investor Alert: Pension or Settlement Income Streams – What You Need to Know Before Buying or Selling Them*](#) (May 2013). *See also* CFPB, [*Consumer Advisory: Protect Your Retirement Pension*](#) (March 2015); Federal Trade Commission, [*Consumer Information: Pension Advances: Not So Fast*](#) (June 2014).
 12. *See* Section 2(a)(1) of the Securities Act of 1933. *See also SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).
 13. 540 U.S. 389 (2004).
 14. *Id.* at 397. *See also Dougherty v. VFG, LLC*, 118 F. Supp. 3d 699 (E.D. Pa. 2015) (treating, without discussion, fixed-income pension stream products sold through a registered representative as securities).
 15. *See In re Prosper Marketplace, Inc.*, Securities Act Release No. 8984 (November 24, 2008).
 16. *See also SEC v. Mut. Benefits Corp.*, 408 F.3d 737, 743-44 (11th Cir. 2005) (stating that both pre- and post-purchase managerial activities should be taken into consideration in determining whether the *Howey* test is satisfied).
 17. *See, e.g., In re Sobell Corp.*, Emergency Cease and Desist Order, Order No. ENF-16-CDO-1741, Texas State Securities Board (February 1, 2016); [*In re VFG, LLC f/k/a Voyager Financial Group*](#), Cease and Desist Order and Notice of Intent to Impose Sanctions, Case No. 13-10-0013, State of New Mexico, Regulation and Licensing Department, Securities Division (December 10, 2013); and [*In re VFG, LLC f/k/a Voyager Financial Group, LLC*](#), Cease and Desist Order, Case No. S-12-0015, Arkansas Securities Commissioner (April 22, 2013). The definition of a “security” under federal and state securities laws may differ.
 18. *See Notice to Members 96-33* (May 1996) (discussing the rule on private securities transactions and stating that “the records created and recordkeeping system used, together with relevant supervisory procedures, must enable the firm to properly supervise the [registered representatives who also are investment advisers (RR/IAs)] by aiding the firm’s understanding of the nature of the service provided by an RR/IA, the scope of the RR/IA’s authority, and the suitability of the transaction”) (emphasis added); *Notice to Members 85-84* (December 1985) (“First, the rationale/purpose behind the rule, as set forth when adopted in 1985, was to address concerns because “securities may be sold to public investors without the benefit of supervision or oversight by a firm and, perhaps, without adequate attention to such regulatory protections as due-diligence investigations and suitability determinations.”) (emphasis added).
 19. Although the focus of this *Notice* is on activities away from an employing firm regarding pension income stream products, firms must consider their obligations under all applicable FINRA rules, including their supervisory obligations under FINRA Rule 3110 (Supervision), if the product is sold as part of the firm’s business.