

NASD NOTICE TO MEMBERS 96-86

NASD Regulation Reminds Members And Associated Persons That Sales Of Variable Contracts Are Subject To NASD Suitability Requirements

Suggested Routing

- Senior Management
- Advertising
- Corporate Finance
- Government Securities
- Institutional
- Internal Audit
- Legal & Compliance
- Municipal
- Mutual Fund
- Operations
- Options
- Registration
- Research
- Syndicate
- Systems
- Trading
- Training

Executive Summary

NASD Regulation, Inc. (NASD Regulation) reminds NASD[®] members and their associated persons who sell variable life insurance contracts and variable annuity contracts (Variable Contracts) of their obligations with respect to the suitability requirements of the NASD Conduct Rules. Variable Contracts are regulated as securities under federal securities laws and NASD rules. Members and their associated persons are reminded that the suitability requirements of NASD Conduct Rule 2310 (formerly Article III, Section 2 of the NASD Rules of Fair Practice) apply to the recommendation of any security, including a Variable Contract. Thus, a member and its associated persons must have reasonable grounds for believing that a Variable Contract recommended to a customer is suitable for that customer.

Questions concerning this Notice may be directed to Robert J. Smith, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Discussion

Variable Contracts are issued by insurance companies and are insurance contracts subject to regulation under state law. Because owners of Variable Contracts assume certain investment risks, the contracts are also considered securities and are registered as such under the Securities Act of 1933. The contracts are funded by a separate account of a life insurance company registered as an investment company under the Investment Company Act of 1940. The distributor of the contracts is a broker/dealer under the Securities Exchange Act of 1934. Thus, an individual who sells a Variable Contract registered with the Securities and Exchange Commission (SEC) must not only be licensed under the applicable state jurisdictions to sell insurance, but must also be appropriately

affiliated with a member and registered as a securities representative with the NASD.

NASD Regulation recently took a disciplinary action against a registered representative for making unsuitable recommendations of variable life insurance contracts to public customers. The registered representative submitted an Offer of Settlement and, without admitting or denying the alleged violations, consented to NASD Regulation's findings that he did not have reasonable grounds for believing that his recommendations to certain public customers to purchase variable life insurance contracts were suitable for the customers based on the facts disclosed to him by the customers relating to their investment objectives, financial situation, and needs. Pursuant to the Offer, NASD Regulation fined the registered representative \$75,000, suspended him for 90 days from the securities industry, required him to return commissions to eight public customers, and required him to requalify before re-entering the securities industry by taking and passing an appropriate qualifying examination. In taking this action, NASD Regulation applied the existing suitability standards enunciated in Rule 2310 to the recommendation of variable life insurance policies.

As securities, the sales and distribution of Variable Contracts are fully subject to the NASD's sales practice rules. The issue of suitability under Rule 2310 arises when a Variable Contract is recommended and sold to a public customer. Rule 2310 requires that, in recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by the customer regarding his or her

© National Association of Securities Dealers, Inc. (NASD), December 1996. All rights reserved.

other securities holdings and financial situation and needs.

In making such recommendations, the member and its registered representatives are required to make reasonable efforts to obtain information concerning the customer's financial and tax status, the customer's financial objectives, and such other information used or considered to be reasonable by the member or registered representative in making recommendations to the customer. Thus, for example, specific factors regarding a recommendation to purchase Variable Products that could be considered under the NASD's suitability rule include: (i) a representation by a customer that his or her life insurance needs were already adequately met; (ii) the customer's express preference for an investment other than an insurance product; (iii) the customer's inability to fully appreciate how much of the purchase payment or premium is allocated to cover insurance or other costs, and a customer's ability to understand the complexity of Variable Products generally; (iv) the customer's willingness to invest a set amount on a yearly basis; (v) the

customer's need for liquidity and short-term investment; (vi) the customer's immediate need for retirement income; and (vii) the customer's investment sophistication and whether he or she is able to monitor the investment experience of the separate account.

Further, as articulated in NASD Conduct Rule IM-2310.2, members and registered representatives have a fundamental responsibility for dealing fairly with their customers. Subparagraph (a)(2) to Rule IM-2310.2 requires, in relevant part, that "...sales efforts must be judged on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed, rather than ...[whether] they result in profits to customers." One of the practices that has resulted in disciplinary action, and that clearly violates the responsibility for fair dealing, is recommending the purchase of securities in amounts that are inconsistent with the reasonable expectation that the customer has the financial ability to meet such a commitment.

Finally, NASD Regulation is aware of the practice whereby a registered representative replaces a customer's existing variable contract with a new variable contract that doesn't improve the customer's existing position, but generates a new sales commission for the registered representative. Such a replacement practice designed merely to generate new sales commissions for the registered representative would be prohibited by NASD Conduct Rules requiring that members and registered representatives deal fairly with customers. In other securities contexts, for example, excessive trading designed solely to generate commissions has resulted in disciplinary action against members for violating their responsibility for fair dealing under Subparagraph (b)(2) to Rule IM-2310.2. "Excessive Trading Activity" is identified as "[e]xcessive activity in a customer's account, often referred to as 'churning' or 'overtrading.'" There are no specific standards to measure excessiveness of activity in customer accounts because this must be related to the objectives and financial situation of the customer involved."