

## **Regulation and Compliance—Variable Annuities**

The Financial Industry Regulatory Authority (FINRA) has long had variable annuities (VAs) on its “radar screen.” FINRA maintains that there is a lack of adequate training and supervision of broker-dealers in connection with VA sales and that firms and individuals do a poor job of assessing suitability for products and riders. The concern is heightened, because a disproportionate number of annuity sales are made to the elderly, who FINRA considers easy prey for unscrupulous sales people.

### **Inadequate Supervision**

In a showing of how serious FINRA is about enforcement of existing laws and regulations, it recently fined five bank broker-dealers a total of \$1.65 million for deficient supervision and procedures related to variable annuity (VA), mutual fund, or unit investment trust (UIT) transactions.

Advisors at each of the firms operated out of branches of affiliated banks, selling VAs, mutual funds or UITs to bank customers, who in many instances were elderly. The brokerage customers were referred by bank personnel, and sales of these financial products represented a significant portion of each firm’s business.

### **Suitability**

In addition, one of the firms charged with inadequate supervision was also charged with unsuitable variable annuity sales to elderly customers. FINRA found that between June 2004 and January 2006 a former advisor at the firm made 32 unsuitable sales to 25 elderly bank customers. The advisor recommended that each customer purchase a VA with an enhanced death benefit rider. The customers, all 78 years old or older, were either too old to be eligible for the rider or very close to the ineligible age. Customers who purchased the VA with the enhanced death benefit rider received little or no benefit from the rider despite paying higher fees for it over the life of the annuity. FINRA ordered the firm to offer the 25 affected customers the opportunity to rescind their unsuitable transactions and receive the initial value of their purchase, plus interest and any surrender charges required, adjusted for any withdrawals made.

FINRA also found that the firm failed to take adequate remedial steps in response to red flags indicating that the advisor in question was engaging in unsuitable VA transactions. Those red flags included nine customer complaints filed against the advisor about her annuity sales and her practice of engaging in a pattern of selling elderly bank customers the same variable annuity with the same enhanced death benefit rider.

The firm placed the advisor under heightened supervision; however, while under such supervision, the advisor engaged in all 32 unsuitable transactions and the firm approved them. FINRA also found that the firm failed to implement adequate VA supervisory systems and procedures.

With respect to another of the five firms, FINRA found that the firm used trade blotters , which did not capture key information, such as the customer's investment time horizon, risk tolerance and other financial assets, to assess suitability and approve VA and mutual fund transactions. Also, important suitability information on the blotters was presented in a way that did not reflect customers' true income or net worth. That is, the blotters reflected only the highest number in the range of values from which they were taken.

It was acknowledged that the firm's Compliance Department performed a review of account documents approximately ten days after transactions were completed to further assess suitability and to ensure that all paperwork had been completed. However, because the transactions had been completed by that time, the Compliance Department often had difficulty obtaining the requested information and completing its review. As a result, FINRA found a large backlog of unapproved transactions developed from 2004 through 2006. That backlog delayed final approval of transactions for weeks, months , and in some cases, for over a year. Despite knowledge of the growing backlog, the firm failed to take effective action to address the problem, which continued until the firm changed to a pre-approval suitability review system between May and August of 2006.

**Regulation and Compliance—Variable Annuities and Suitability**As a result of problems like these, FINRA promulgated a special variable annuity sales rule — Rule 2821. The rule was approved by the SEC on September 7, 2007 and became effective in May of 2008. Although the activities described above apparently took place before the effective date of the new rule, it is likely that the new rule will be relied on to go after such activities in the future.

## Summary of Rule 2821

Rule 2821 establishes new requirements in four areas:

1. Suitability;
2. Principal review and approval;
3. Supervisory procedures; and
4. Training

*The SEC appears to be serving notice that it expects securities firms to perform some sort of assessment of their clients' mental competence before recommending any investment including variable annuities. This is in keeping with the SEC's concern that annuities, especially, are often marketed to the elderly, who may lack the mental competence to judge their own suitability for sophisticated products and rides.*

### *Suitability: Rule 2821(b)*

Rule 2821(b) imposes special suitability obligations on registered representatives who recommend the purchase or exchange of a deferred variable annuity. Before recommending a purchase or exchange of a variable annuity, the representative must have a "reasonable basis" to believe that the transaction is suitable.

Specifically, this means that:

1. The customer has been informed about the various features of variable annuities generally;
2. The customer would benefit from "certain features" of deferred variable annuities (such as tax-deferred growth, annuitization, or a death or living benefit); and
3. Both the contract itself (including any riders) and the underlying sub-accounts in which the customer's premiums are initially to be invested are suitable.

If an IRC Section 1035 exchange is involved, the representative must also weigh (and disclose) whether the customer is going to pay a surrender charge, be subject to a new surrender period, lose existing benefits, or be subject to increased fees or charges such as mortality and expense fees. The representative also must have a basis for believing that the exchange will benefit the client. Finally, the representative must consider whether "the customer's account has had another deferred variable annuity exchange within the preceding 36 months."

All of these considerations have to be documented in writing *and signed* by the representative. In addition, prior to recommending a variable annuity, the representative must "make reasonable

efforts to obtain” a dozen itemized categories of information, including a customer’s existing assets, liquidity needs, liquid net worth, tax status, and “intended use of the deferred variable annuity,” the latter being a unique requirement.

Finally, while not formally part of Rule 2821, the SEC’s release approving the rule contained a footnote which stated that, “(T)he general suitability obligation requires a broker-dealer to consider its customer’s ability to *understand* the security being recommended, *including changes in the customer’s ability to understand, monitor, and make further decisions regarding securities over time.*”

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#### *Principal Review and Approval: Rule 2821(c)*

Rule 2821(c) also imposes unusual review and approval requirements. A registered principal must review and approve in writing all variable annuity applications *before* they are transmitted to the insurance company, but within seven business days of the date that the customer signs the application. Furthermore, a registered principal must review all variable annuity transactions before they take place, whether recommended or not, and if the principal finds that an unsolicited purchase may not be suitable, the supervisor may authorize the transaction only if the customer is informed that the supervisor has not approved the transaction and the reason(s) why, and the client affirms that he or she wants to proceed with the purchase anyway. As with the registered representative’s review, the principal’s suitability determinations must be documented in a signed writing and must take into account all of the same factors.

#### *Supervisory and Compliance Procedures: Rule 2821(d)*

Member firms must maintain specific written supervisory procedures for complying with Rule 2821. Firms also must implement special compliance procedures designed to determine if their registered representatives are engaging in excessive switching and must adopt policies and procedures designed to implement “corrective measures” with respect to “inappropriate exchanges” and the conduct of representatives who engage in those transactions.

### *Training: Rule 2821(e)*

Under this section, member firms must develop and implement special training programs designed to ensure that both registered representatives and registered principals understand the variable annuity products they are selling or approving and the special requirements of Rule 2821.

### **What it Means**

FINRA's recent enforcement action signals that it continues to consider VA sales an area of concern and that it is serious about enforcement.

Compliance with the law requires additional paperwork for advisors and principals. It requires firms to implement training programs and put in place policies and procedures to assure adequate supervision and suitability.

Exchanges of annuities, which often result in the payment of new commissions to the seller and the beginning of a new surrender charge period, are likely to come under special scrutiny. Another problem area relates to riders that provide death benefits and/or guarantees of benefits. Advisors must understand the trade-offs associated with such riders and be able to evaluate their appropriateness for clients. In addition, advisors must be able to adequately explain the operation of such riders to clients in order to minimize the potential for complaints.

### **Bottom Line**

Rule 2821 makes it harder to sell variable annuities, but this doesn't mean you shouldn't sell them when appropriate for the client. Keep in mind that VAs are unique in their ability to combine participation in the equity market with tax-deferred growth and a lifetime guaranteed income.

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