I. INTRODUCTION

“The times they are a changing.” Those are the words Paul Roye, Director of the Division of Investment Management of the U.S. Securities and Exchange Commission (“SEC”), used to describe the variable insurance products industry at the October 2000 ALI-ABA Conference. Indeed, in the last decade, the variable insurance industry has changed dramatically, experiencing exponential growth in sales and distribution channels. The most

1 For convenience, this outline uses the term “SEC” to refer collectively to the Securities and Exchange Commission and its staff, and uses the term “NASD” to refer collectively to the National Association of Securities Dealers, Inc., NASD Regulation, Inc., and their respective staffs, except as otherwise noted.
2 For the purposes of this outline, “variable insurance products” or “variable products” include both variable annuities and variable life insurance.
4 At the end of 1990, the industry had assets of $34.7 billion. By March 2000, the industry’s assets had increased more than 24-fold to $847.9 billion. See Remarks of Paul Roye, Director of the Division of Management, U.S. Securities & Exchange Commission, before the National Association for Variable Annuities Regulatory Affairs Conference, Washington, D.C. (June 5, 2000), reprinted at <<www.sec.gov/news/speech/spch379.htm>> (visited Aug. 13, 2001).
5 “A survey by Kenneth Kehrer Associates, an independent consulting firm in Princeton, N.J., found that sales of annuities through banks reached $32.7 billion last year, a 20% increase over 1999 and an all-time record for such bank sales. While the study shows that captive agencies still accounted for 34%, or the bulk of sales of life insurance and annuities in 2000, the remainder was distributed among banks and credit unions, independent firms and regional
significant change, however, is the unprecedented scrutiny by the securities regulators of the suitability of sales of variable products and the supervision of same.

Early this year, the National Association of Securities Dealers Regulation (“NASDR”) filed six disciplinary actions against member firms for the alleged improper marketing and sale of variable annuities. These actions were the first resulting from a series of targeted examinations (also known as “sweeps”), conducted by the NASDR in 1998, 1999 and 2000, focusing on the supervision and the suitability of variable products. On the same day as the disciplinary actions were filed, the NASDR released an “Investor Alert,” identifying various reasons for and against making a variable annuity Section 1035 exchange, and noting that an exchange of insurance or annuity contracts may not necessarily be a good idea. The significance of these enforcement actions was not in the amount of penalties assessed -- a total of only approximately $112,000 for the six actions -- but, instead, in the coordinated, simultaneous filing of six actions together with the release of the Investor Alert. This coordination was designed to highlight the increasing attention the NASDR is devoting to perceived sales practice violations in the variable product arena.

Industry insiders report that the NASDR has completed the “second round” of sweep examinations, and at least six additional disciplinary actions are expected to be announced by late 2001. As Barry Goldsmith, the head of NASDR’s Division of Enforcement, promised, it is expected that the “second round” enforcement cases will reflect a significant “ratcheting up” of sanctions, with potential six-figure fines and suspensions from supervisory positions possible. The NASDR is now focusing on the follow-up to a “third round” of sweep examinations with on-the-record testimony being taken from compliance personnel responsible for the design of supervisory systems and written supervisory procedures, principals responsible for suitability “sign-off,” and registered representatives. Further, document requests pursuant to Rule 8210 are resulting in tens of thousands of pages being produced in the examinations and investigations. To best illustrate the scope of the examinations and investigations, see a copy of standard document requests attached hereto as Exhibit 1, which touches on all aspects of the sales process regarding variable products, and Exhibit 2, which touches on bonus annuities and dollar cost averaging programs.

At least one industry commentator expects the “biggest blow” to the industry will come from the SEC. In recent months, the SEC’s investigations have focused primarily on the suitability and sale of bonus annuities. According to Paul J. Mason, former executive director investment firms.” Annuity Sales Practices Under Scrutiny, IMSA Warns, Best’s Ins. News (Mar. 16, 2001).

Among other issues, the examinations have looked at the sales of qualified annuities into tax-deferred accounts, the sale of variable annuities to elderly clients, and 1035 exchanges. Annuity Sales Practices Under Scrutiny, IMSA Warns, Best’s Ins. News (Mar. 16, 2001).

The SEC staff also has expressed concerns that insurers may be interpreting the “retail exception” under Section 11 of the Investment Company Act of 1940 too broadly when variable contracts issued by an insurer are exchanged for other contracts issued by the same insurer.
of the Insurance Marketplace Standards Association, “it appears more likely than not that [the Commission] will be bringing some major cases -- most likely in suitability and supervision.”

Although there are strong arguments that an insurer should have no responsibility for supervising its affiliated broker-dealers’ sales practices, the securities regulators do not seem convinced. The debate regarding whether the wholesaling firms, distributors or insurers bear some responsibility for the selling firm’s and the registered person’s compliance with the NASD Conduct Rules and SEC rules and regulations is ongoing. In a speech before the insurance industry last year, Paul Roye remarked “insurers cannot act like ostriches and bury their heads in the sand when it comes to sales practice issues. Inappropriate sales practices not only taint the broker-dealer firm selling the product, but can also cause damage to the reputation of the insurer providing the product.” In the Variable Annuity Notice to Members 99-35, the NASD observed that wholesaling firms also bear some responsibility for sales practices by retail firms. Specifically, the NASD noted that wholesaling firms “should avoid marketing strategies that are designed primarily to encourage inappropriate replacement sales.” Furthermore, the NASD notes that wholesaling firms, upon “reasonable request and to the extent practical . . . should assist retail [firms] in monitoring the replacement activity of their customers.”

No one knows how far the SEC will go in an enforcement action to define the responsibilities of the wholesaling firms or variable product insurers. While the insurer ordinarily is not registered as a broker-dealer and, therefore, is not directly subject to NASD jurisdiction, as the sponsor or depositor of the separate account registered with the SEC, an insurer is subject to SEC regulation. As a practical matter, however, when the variable product insurer’s distribution channel is the subject of an investigation by the SEC or NASD, the insurer is negatively affected. Proceedings suspending high level principals or members of the sales force can be devastating to a broker-dealer and, consequently, to the insurance provider. Investigations take years and the variable insurer and wholesalers will be required to produce documents and provide testimony in the investigation, costing the insurer time, money and valuable resources. Regulatory actions result in bad press for the insurer, its affiliated broker-dealer, and its registered representatives.

11 NASD Notice to Members 99-35, The NASD Reminds Members of Their Responsibilities Regarding the Sales of Variable Annuities, paragraph 16 (May 1999).
12 Id.
13 The insurer is not required to become registered as a broker-dealer to offer and sell variable products if its subsidiary broker-dealer is registered and certain conditions are met. See Distributions of Variable Annuities by Insurance Companies, Broker-Dealer Registration and Regulation Problems Under the Securities Exchange Act of 1934, Exchange Act Rel. No. 8389, 1968 S.E.C. LEXIS 140 (Aug. 29, 1968).
Insufficient attention by a broker-dealer to the weaknesses in its supervisory system could lead to an insurer becoming involved in a lengthy securities investigation, especially where the processor in the insurance company’s new business department wears two hats: that of the insurance company processor and of the principal reviewing the transaction. Insurers should consider taking proactive measures with their affiliated broker-dealers to determine whether the broker-dealers’ supervisory systems are adequate to meet the requirements and expectations articulated in the recent enforcement actions and pronouncements. Therefore, this outline explains the suitability and supervisory systems required by the NASD Conduct Rules, summarizes the recent enforcement actions and what insurers can expect in the future, and identifies practices that raise “red flags” indicating the broker-dealer’s supervisory system of the sale of variable products may not stand up under the scrutiny of securities regulators.  

II. NASD AND SEC REGULATION OF VARIABLE PRODUCT SALES

Variable product sales implicate a number of NASD rules and interpretive guidelines. NASD Conduct Rules 3010 (the “Supervision Rule”), 2310 (the “Suitability Rule”), and 3110 (the “Customer Account Rule”) shape the process a member firm should follow in supervising sales practices and determining suitability compliance. These rules contemplate a supervisory process in which a designated supervisor reviews and approves the opening of an account and a variable product transaction pursuant to standards established by the member firm taking into account the information collected about the customer.

To better understand these requirements, a summary of the relevant suitability and sales practices rules and guidance provided by the SEC and the NASD is warranted.

A. NASD Conduct Rule 3010 - The Supervision Rule

Among other things, this rule establishes the requirement for supervisory review and approval of all securities transactions effected by a member firm.

- **Principal Approval.** Rule 3010(d) requires a member firm to adopt procedures for the review and endorsement by a designated registered principal of all transactions.

- **Review Process.** Inherent in the approval requirements is the expectation that the principal will conduct a review of each order. Although not specified in the rule, in various contexts the NASD has indicated that firms should adopt processes for the “heightened review” of transactions outside established parameters.

B. NASD Conduct Rule 2310 - The Suitability Rule

14 For a comprehensive discussion of the 1999 enforcement actions and a description of issues the insurer should consider if its affiliated broker-dealer is the subject of a regulatory investigation, see The SEC and NASD Have Sent a Wake Up Call to the Insurance Companies Issuing Variable Products: The Question is “How is the Industry Responding?,” written by Peter J. Anderson for the 2000 American Law Institute-American Bar Association Conference on Life Insurance Company Products: Current Securities, Tax, ERISA, Offshore, and State Regulatory Issues (Oct. 2000).
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 other securities holdings and financial situation and needs.

- In making a recommendation, a member and its registered representatives must make reasonable efforts to obtain information concerning the customer’s financial and tax status, the customer’s financial objectives, and any other relevant information.

  o Relevant information includes:

    1. customer’s representation that he has adequate insurance coverage;
    2. customer’s express preference for investment other than insurance product;
    3. customer’s ability to understand the complexity of variable products;
    4. customer’s willingness to invest a set amount on a yearly basis;
    5. customer’s need for liquidity and short-term investment;
    6. customer’s immediate need for retirement income; and
    7. customer’s investment sophistication.

The relevant information MUST BE DOCUMENTED.

- **Institutional Customers.** The NASD has adopted an interpretation, IM-2310-3, providing guidance for applying the Suitability Rule to institutional customers.

  o **Definition.** The interpretation indicates that an institutional customer is any entity other than a natural person, and that the guidance is more appropriately applied to an institutional customer with at least $10 million invested in securities in the aggregate in its portfolio and/or under management. (See NASD Rule 3110(c)(4) for full definition of an institutional account.)

  o **Satisfying the Duty.** In the case of an institutional investor, a member firm’s obligation to determine that a recommendation is suitable is fulfilled where the broker-dealer has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk.
Relevance to Variable Products. This interpretation is of relevance to sales of variable products made in the qualified market, in the context of employers meeting the institutional investor standard.

C. Fair Dealing IM-2310-2

Associated with the Suitability Rule is the NASD’s “fair dealing” interpretation, codified as IM-2310-2. This long-standing interpretation explains that member firms have the fundamental responsibility for fair dealing with customers. Of relevance to variable products, the interpretation warns that excessive trading in a customer’s account, or trading in mutual fund shares on a short-term basis, may be practices that violate the duty of fair dealing. The interpretation also notes that the duty of fair dealing could be violated by the recommendation to make “continuous purchases of securities in amounts which are inconsistent with the reasonable expectation that the customer has the financial ability to meet such commitments.” The NASD has indicated that this practice would include a situation in which a member firm or registered representative recommended the purchase of variable life insurance (“VLI”) based upon periodic payments that the investor could not reasonably be expected to continue to make.

D. NASD Notice To Members 96-86 (“VLI Notice”)\(^\text{15}\)

This notice, issued in December 1996, provides guidance for (VLI) sales based in part on enforcement proceedings brought against a sales representative for making unsuitable recommendations relating to VLI contracts. This notice specifies seven factors that “could be considered” under the Suitability Rule, such as:

- Whether the customer had represented that his or her life insurance needs were already adequately met;
- Whether the customer had expressed a preference for an investment rather than an insurance product;
- Whether the customer had the ability to fully appreciate how much of the purchase payment is allocated to cover insurance or other costs, and his ability to understand the complexity of variable products generally;
- The customer’s willingness to invest a set amount on a yearly basis;
- The customer’s need for liquidity and short-term investment;
- The customer’s immediate need for retirement income; and
- The customer’s investment sophistication and whether he or she is able to monitor the investment experience of the separate account.

\(^\text{15}\) NASD Notice to Members 96-86, The NASD Regulation Reminds Members and Associated Persons that Sales of Variable Contracts are Subject to NASD Suitability Requirements, (Dec. 1996).
E. NASD Conduct Rule 3110 – The Customer Account Rule

Rule 3110(c) specifies information that member firms should maintain for each customer account. The rule distinguishes between mandatory information and recommended information.

- **Mandatory Information.** For all accounts opened after January 1, 1991, a member firm is required to maintain records of the customer’s name and residence, whether the customer is of legal age, as well as the signature of the registered representative introducing the account and the signature of the officer or manager accepting the account. If the customer is a corporation, partnership or other legal entity, the names of any person authorized to transact business on behalf of the entity must be maintained.

- **Additional Information.** A member firm is also required to use reasonable efforts to obtain the customer’s tax identification number, occupation of the customer and employer’s name and address, and whether the customer is an associated person of another member firm. This requirement does not apply to:
  - Institutional customers; and
  - Accounts limited to transactions in mutual funds that are not recommended by the member firm or its associated persons.

- **Comparison to the Suitability Rule.** The information required by Rule 3110 is separate from whatever information-gathering requirements may apply under Rule 2310, a point made in IM-3110, which reminds member firms that additional information is required to be obtained prior to making recommendations to customers.

- **Approval of Customer Accounts.** This Rule requires that an officer or manager “accept” a customer account, implying that a firm should adopt procedures and standards for the review by a designated registered principal of the acceptance of accounts. While the NASD has not provided much guidance for the approval of customer accounts, the guidance generally suggests that member firms should have standards for approving customer accounts, including a heightened review process for customer accounts outside established parameters.

III. WHAT THE REGULATORS EXPECT

In 1999 and 2000, NASDR issued guidance to its members in Notices to Members 99-35 and 00-44 on how a broker-dealer should sell variable products. In 2001, NASDR issued Notice to Members 01-23 giving broker-dealers guidance on the appreciation of the suitability rule. This guidance, coupled with the NASD Rules, is the roadmap an insurer can use to determine if its affiliated broker-dealer is in compliance with the NASD’s requirements.
A. NASD Notice to Members 99-35 (“VA Notice”)\textsuperscript{16}

This Notice provides guidance relating to the suitability analysis underlying a variable annuity recommendation and point of sale disclosures. The VA Notice indicates that, in addition to the customer information specified in the NASD Conduct Rules, a member firm and its registered representatives should make “reasonable efforts to obtain comprehensive customer information,” including:

1. Marital status;
2. Age;
3. Number of dependants;
4. Risk of tolerance;
5. Previous investment experience;
6. Liquid net worth;
7. Other investments and savings; and
8. Annual income.

This information MUST BE DOCUMENTED by the registered representative.

1. Recommending Variable Annuities. NTM 99-35 offers a number of suggestions for members to consider in conducting suitability analyses.

a. Know the Product. NTM 99-35 recommends the registered representative should have a thorough knowledge of the specifications of each variable annuity that is recommended, including the death benefit, fees and expenses, sub-account choices, special features, withdrawal privileges and tax treatment.

b. Collect Comprehensive Customer Information. NTM 99-35 suggests that perhaps more information than would otherwise be the case may need to be collected by a registered representative recommending a variable annuity to support a recommendation. More particularly, the notice recommends that both members and their registered representatives make “reasonable efforts” not only to obtain the basic information required by NASD Rule 2310 -- a customer’s financial and tax status, investment objectives, and such other information used or considered reasonable in making a recommendation to a customer -- but also more comprehensive information, such as the customer’s occupation,

\textsuperscript{16} NASD Notice to Members 99-35, The NASD Reminds Members of Their Responsibilities Regarding the Sales of Variable Annuities, (May 1999).
marital status, age, number of dependents, investment objectives, risk tolerance, tax status, previous investment experience, liquid net worth, other investments and savings, and annual income.

c. Determine Long-Term Investment Objective. NTM 99-35 suggests that a variable annuity should be recommended only when its other benefits, such as lifetime income payments, death benefit, and guaranteed fees, support the recommendation.

2. Recommending a Replacement. NTM 99-35 focuses attention on replacements sales and suggests that firms observe the following practices:

a. Determine the Replacement is Suitable. NTM 99-35 advises that a registered representative should determine that a recommendation to replace an existing variable product with a new product is suitable for the customer, based on the information provided by the customer and the registered representative’s knowledge of the product features, such as product enhancements and improvements, lower cost structures and surrender charges.

b. Avoid Marketing Strategies that Encourage Inappropriate Replacements. NTM 99-35 advises wholesaling firms that they should avoid marketing strategies designed primarily to encourage inappropriate replacement sales.

3. Recommending a Variable Annuity for a Tax-Qualified Account. NTM 99-35 recommends more stringent standards when a registered representative recommends a variable annuity for a tax-qualified account.

a. Special Disclosures. The notice advises that the registered representative should disclose to the customer that the tax-qualified retirement plan provides a tax deferral feature and that the tax deferral feature of the variable annuity is therefore unnecessary.

b. Special Considerations. The notice also suggests that a registered representative ought to recommend a variable annuity only in those circumstances when its other benefits, such as lifetime income payments, family protection through the benefit, and guaranteed fees, support the recommendation.

4. Recommending a Variable Product for an Asset Allocation Program. The NASD acknowledges that a variable annuity recommendation may be made in the context of recommending which portion of the customer’s investable funds in an asset allocation program be invested in the annuity. In such a situation, the NASD has cautioned, the specific annuity that is sold must still fit the customer’s investment objective, and the firm should consider how the annuity fits in the

5. **Point of Sale Disclosures.** NTM 99-35 recommends that a registered representative discuss certain information with purchasers in connection with presenting a variable annuity.

   a. **General.** The notice suggests that the registered representative discuss all relevant facts with the customer, including liquidity issues; fees, including mortality and expense charges; administrative charges; investment advisory fees; and market risk.

   b. **Point of Sale Disclosures for Older Purchasers.** In the case of customers who are age 59-1/2 or older, the notice suggests that the registered representative inform the customer when surrender charges apply to withdrawals, presumably because of potential confusion about tax penalties and surrender charges.

6. **Deliver a Prospectus.** NTM 99-35 suggests that a current prospectus be given to the customer when a variable annuity is recommended, to the extent practicable. NTM 99-35 also envisioned that the registered representative would discuss certain prospectus information with the customer, such as fees and expenses and the illiquidity of the product.

7. **Sales Material Used Must be Approved by the Firm.** NTM 99-35 reminds registered representatives that they may use only sales material that is approved by a registered principal of the firm. This reminder is consistent with the position the NASD has taken for some time that member firms must comply with internal review and approval requirements for sales materials provided to them by other firms. See, e.g., “Ask the Analyst” in NASD Alert (Mar. 1994) and “Ask the Analyst” in NASD Alert (Oct. 1995). It also reinforces the need for selling firms to develop procedures and processes to ensure that they review on a pre-use basis any materials that may be provided by insurers or wholesalers directly to their registered representatives.

B. **NASD Notice to Members 00-44 (“VLI Notice II”)**

This notice, issued in June 2000, is the VLI companion notice to the VA Notice, and provides guidance for member firms selling variable life insurance policies. This notice lists informational items that a member firm and its sales representatives should make reasonable efforts to obtain before execution of a recommended VLI transaction. In addition to the factors identified above in the VA Notice, VLI Notice II also mentions:

- Sources of funds for the investment;

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17 NASD Notice to Members 00-44, The NASD Reminds Members of Their Responsibilities Regarding the Sale of Variable Life Insurance, (July 2000).
• Existing life insurance; and

• Time horizon.

NTM 00-44 suggests broker-dealers may wish to design their own supervisory system to monitor variable life insurance sales activities based upon the broker-dealer’s organization and structure. The NASD observed that for some broker-dealers with offices that are geographically dispersed, a decentralized supervisory system may be appropriate while a more centralized system may be appropriate for other offices. The system should provide customers with an easy and expeditious way to communicate complaints, and have a system whereby the customer complaints are acted upon, analyzed, and researched.

NTM 00-44 provides a set of guidelines to assist members in developing appropriate supervisory procedures for sales of variable life insurance. Included in those guidelines are the following:

1. **Registered Principal Review.** NTM 00-44 advises the registered principal to review the account information form and verify that the recommendation is suitable, considering whether the customer desires and needs life insurance and whether the customer can afford the premiums likely needed to keep the policy in force. The member firm is encouraged to retain suitability information. NTM 00-44 gives suggestions on internal procedures the broker-dealer may consider using to assist in the suitability review.

2. **Internal Percentage Ratio Guidelines.** As one tool for evaluating if the sale is suitable, NTM 00-44 suggests the member firm may wish to establish internal percentage ratio guidelines, such as ratio of scheduled or target premium to income or household income. If parameters are exceeded, registered representatives should be required to submit additional supporting documentation and explain in writing why the sale is suitable. If the factors indicate a sale exceeds the internal percentage ratio guidelines, an extra level of supervision and review may be warranted. NTM 00-44 is careful to say that these ratio guidelines are not substitutes for supervision, but should be viewed as tools to assist supervisors in the suitability review process.

3. **Checklists.** NTM 00-44 suggests that the broker-dealer create checklists of items the registered principal should review and evaluate when determining if the product is suitable.

4. **Older Customers.** NTM 00-44 suggests member firms may wish to establish special supervision requirements for sales to older customers.

5. **Examples of Unsuitable Recommendations.** NTM 00-44 advises member firms may wish to provide registered representatives with examples of what the member considers to be potentially unsuitable recommendations and what type of activity would warrant an extra level of supervisory review.
6. **Replacements and Compliance Reports.** NTM 00-44 suggests that member firms develop procedures to review replacement recommendations for suitability to determine if the replacement transactions are suitable. As part of that supervision, NTM 00-44 suggests member firms create compliance reports to track replacement activity by each registered representative, with high levels of activity triggering additional review. Broker-dealers are encouraged to use quarterly 1035 exchange reports or other reports created by the insurance companies such as reports on surrenders, reduced face amounts, lapses, and modified surrenders to detect red flags triggering additional review. NTM 00-44 suggests wholesale member firms should assist retail broker-dealers in monitoring replacement activity.

Broker-dealers are encouraged to develop replacement disclosure forms or use forms authorized by a state insurance commission or other regulatory body.

7. **Life Insurance Financing.** NTM 00-44 states that broker-dealers should not recommend a customer finance a variable life insurance policy from the value of another insurance product, unless the transaction is otherwise suitable. When financing is recommended, the NASD suggests the registered representative disclose the potential consequences for both the existing and new policies and recommends that the member firm provide a form that documents the customer’s informed consent to financing. The form should include the customer’s acknowledgment, the registered representative’s signature, and a registered principal’s signature.

NTM 00-44 encourages broker-dealers to create a system that matches new policies with disbursements from existing policies for a set time and to track that activity. Broker-dealers are encouraged to consider whether to vary review and report periods in order to prevent registered representatives from timing financed or replaced transactions to escape detection.

8. **Advertising and Sales Literature.** NTM 00-44 reiterates that broker-dealers must develop procedures to ensure that all advertisements and sales literature are approved in writing by a registered principal prior to use. NTM 00-44 contains the following restatements of existing NASD requirements for individual VLI sales materials and advertising:

   a. Broker-dealers are required to file the format for hypothetical illustrations used in the promotion of variable life insurance policies, since these formats qualify as sales literature.

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18 Under NASD Rule 2210, broker-dealers must file with NASDR’s Advertising/Investment Companies Regulation Department all variable life insurance and advertisements and sales literature within ten days of first use or publication.
b. Any communication discussing the tax-deferral benefits of variable life insurance should not obscure or diminish the importance of life insurance features of the product.

c. Any variable life insurance communication that overemphasizes the investment aspects of the policy or potential performance of the sub-accounts may be misleading.

C. NASD Notice to Members 01-23 (The Reasonable Basis Theory)

In March 2001 the NASDR issued this guidance to its members regarding the application of the NASD’s suitability rule to the online brokerage industry. Although the guidance focuses on the online communications, the NASDR’s suitability discussion is relevant to the traditional in-person communication. In footnote 4, the NASDR explains the “reasonable basis theory.” The NASDR states, in part:

A broker/dealer must also have a reasonable basis “to believe that the recommendation should be suitable for at least some customers.” In re F.J. Kaufman and Company of Virginia, 50 S.E.C. 164, 168, 1989 SEC LEXIS 2376, *10 (1989) (emphasis in original). This is called “reasonable basis” suitability, and it “relates only to the particular recommendation, rather than to any particular customer.” Id. See also In Re Charles E. Marland & Co., Inc., 45 S.E.C. 632, 636, 1974 SEC LEXIS 2458, *10 (1974) (Recommending mutual fund switching creates rebuttable presumption of unsuitability); In re Thomas Arthur Stewart, 20 S.E.C. 196, 207, 1945 SEC LEXIS 318, *25 (1945) (“[T]he lack of reasonable grounds for recommending [switching shares of mutual funds]” was the basis for finding broker had violated NASD’s suitability rule based on “reasonable basis” theory.).

Although not directly addressed in this Policy Statement, in certain instances, a suitability violation also can be based on an inappropriate frequency of trades, often referred to as excessive trading or churning. See IM-2310-2, Fair Dealing With Customers (“Some practices that have resulted in disciplinary action and that clearly violate this responsibility for fair dealing . . . . [e]xcessive activity in a customer’s account.”). A broker/dealer could violate the suitability rule, for example, where it recommended to a customer an excessive (and, based on the customer’s financial situation and needs, an inappropriate) number of securities transactions and the customer routinely followed the broker/dealer’s recommendations. See, e.g., In re Harry Gliksman, Exchange Act Rel. No. 42255, at 4, 1999 SEC LEXIS 2685, at *6 (Dec. 20, 1999) (“Under [Rule 2310], recommendations may be unsuitable if the trading is excessive based on the customer’s objectives and financial situation.”); In re Rafael Pinchas, Exchange Act Rel. No. 41816, at 11-12, 1999 SEC LEXIS 1754, at *22 (Sept. 1, 1999)

19 NASD Notice to Member 01-23, Suitability Rule and Online Communications, (Mar. 2001)
(“Excessive trading, by itself, can violate NASD suitability standards by representing an unsuitable frequency of trading”).

This footnote advises that suitability is a two step process. The registered representative must first determine if the product is suitable for the type of account at issue, and if so, then, he or she should determine if the product is suitable in light of the particular needs of the customer.

This footnote is particularly instructive to a registered representative in recommending replacements. For example, before recommending an investor replace a variable annuity, the registered representative should look at the characteristics of the product the investor presently owned and compare it to the recommended replacement product. If the replacement product, as a whole, is not a better product, then the registered representative should not recommend the replacement. If it is a better product, then the registered representative would take the next step, to determine if the replacement variable product was suitable in light of the customer’s particular needs, the costs occasioned by the replacement, the time horizon of the investor and other factors.

As part of the supervision process, broker-dealers should consider establishing “product guidelines or suitability rules”—minimal guidelines that would define the type of account in which a certain product is suitable, such as a certain age or income parameters, without regard for the customer’s individual needs. Exception reports could be developed to detect products that are sold to individuals that do not fall within the product suitability guidelines. For example, a broker-dealer could establish guidelines which provide that the product may only be sold to individuals between 21 years old and 70 years old, with an income of $25,000 or more. If the product is sold to an individual who does not meet the product suitability guidelines, the exception reports would identify that person and the sale would be questioned. The insurance provider could also establish guidelines for the product or work with the broker-dealer to establish the guidelines.

IV. REGULATORY ACTIONS

In 1998, regulators began examinations or “sweeps” of insurance company-affiliated broker-dealers, which included investigations regarding the sales of qualified annuities into tax-deferred accounts (such as IRAs), the sale of variable annuities to elderly clients, the replacement of policies, and “bonus programs.” To date, these “sweeps” have resulted in the SEC bringing an enforcement action in September 2000, and the NASDR bringing six disciplinary actions in February 2001.

A. In re Raymond A. Parkins, Jr.

In September 2000, the SEC commenced administrative proceedings against the president of a broker-dealer, based on allegations that he had violated, among other things, Section 17(a) of the 1933 Act and Rule 10b-5 under the 1934 Act, in connection with making “switches” in variable annuities. See In re Raymond A. Parkins, Jr., SEC Admin. Proc. No. 3-10300 (Sept. 25, 2000). In the first cease-and-desist order filed by the SEC, the Commission alleged that the respondent, Raymond Parkins, induced his investment advisory clients to switch
variable annuities by providing them with false and misleading justifications for the switches and by misrepresenting or failing to inform them of the sales charges associated with the switches.

The SEC alleged that between 1993 and 1996, Mr. Parkins sent a total of 24 letters to eight clients recommending that they exchange variable annuities he had previously sold them for new ones. Often, he told clients that no fees would be incurred, or fees would be “nominal,” according to the SEC. With each letter, the SEC notes, he included the appropriate forms to sign to effect the switch; all authorized the swap.

The exchanges cost the clients $168,000 in fees and generated a total of $210,000 in commissions for Mr. Parkins, according to the SEC’s complaint. In one year alone, the SEC says, annuity exchanges accounted for half of the commission income at Orlando, Florida’s Parkins Securities, which closed in July 1999.

In public appearances shortly after the commencement of this action, senior SEC officials referred to the proceeding as a signal to the industry of the SEC’s intent to apply to variable product exchanges the same standards that have been applied to mutual fund switches. The proceedings are ongoing.

B. NASDR Disciplinary Actions

On February 15, 2001, the NASDR announced it was bringing six disciplinary actions against member firms for violations of NASD Conduct Rules 3010 (the Supervision Rule), 2310 (the Suitability Rule) and 2110, among others.20 Rule 2110, entitled “Standards of Commercial Honor and Principles of Trade,” provides that “[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.”

These disciplinary actions were the first resulting from a series of special examinations focusing on sales of variable contracts conducted by the NASDR during 1999 and 2000 and were investigated by NASDR offices in New Orleans and Dallas. The NASDR brought actions against insurance-affiliated broker-dealers, a bank-affiliated broker-dealer, independent broker-dealers and an individual, sending the message that no firm is immune from the NASDR’s variable annuities sales practices investigations. While the actions name a diverse group of respondents, all six cases emphasize the need for broker-dealers to establish written procedures to ensure the collection and maintenance of applicable customer information and the supervisory review of variable product sales.

Five of the cases were settled by entry of Letters of Acceptance, Waiver and Consent (“AWCs”), with sanctions including censures and fines ranging from $10,000 to $32,500 and restitution to an affected public customer. The details of these cases follow:

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20 In First Union Brokerage Services, Inc., Case Number C05010010, the NASDR found that the firm violated NASD Conduct Rule 1120(a)(1)(A) (Membership Registration), NASD Conduct Rule 3360 (Short-Interest Reporting) and SEC Rule 17a-4(a).
• Prudential Securities, Inc. – Case Number C05010005
The firm agreed to a censure and a $10,000 fine based on findings that it failed to enforce its written procedures relating to the sale of annuities. Specifically, NASDR alleged that its review of 201 sales of variable annuities revealed several instances in which documents required by the firm’s written procedures -- such as order tickets, 1035 exchange forms, and replacement disclosure letters -- were missing.

• First Union Brokerage Services, Inc. – Case Number C05010010
The firm agreed to a censure and a $32,500 fine (which included $5,000 of disgorgement) based on NASDR’s findings that it failed to establish and maintain adequate written procedures to supervise the sale of variable annuities. NASDR specifically noted that the procedures did not explain:

- how and when to conduct and evidence the review of variable annuity sales;
- how to supervise the suitability of the allocation of premium payments to the sub-accounts; and
- which review responsibilities could be delegated to registered representatives and how registered principals would supervise such responsibilities.

NASDR also noted that the following violations:

- The firm failed to obtain customer information and other documentation required by its written procedures, such as net worth, annual income, investment objectives, risk tolerance, time horizon, tax status or other qualified investment information.
- The firm failed to demonstrate it had delivered prospectuses and obtained disclosure forms.
- The firm allowed two individuals to perform duties as registered representatives and/or to receive compensation for which registration is required, while these individuals were inactive for failing to complete the Regulatory Continuing Education Requirements.

• Allmerica Investments, Inc. – Case Number C05010004
The firm agreed to a censure and a $15,000 fine based on NASDR’s findings that it failed to establish, maintain, and enforce adequate written procedures to supervise the sale of variable annuities. Specifically, NASDR noted that for most sales of variable annuities, the only document
required to be submitted for review by a registered principal was a form that asked applicants to classify their objectives as either “retirement” or “other.” NASDR found that this information was insufficient to allow a registered principal to determine a customer’s investment objectives.

- **Ralph C. Evans – Case Number C05010009**
  Mr. Evans agreed to a censure, a $10,000 fine, and restitution of $20,130.61 to the affected customer based on NASDR’s findings that he recommended an unsuitable sale of a variable annuity to a 76 year-old widow. NASDR found that funds for the purchase were derived from the sale of Class B mutual funds (for which the account incurred contingent deferred sales charges) and from a margin loan. NASDR found the transaction unsuitable because Mr. Evans did not evaluate whether the anticipated holding period was sufficiently long such that the tax-deferred benefits of the annuity would be likely to outweigh the additional cost associated with the annuity (including the CDSCs on the mutual fund shares and the margin interest).

- **Lutheran Brotherhood Securities Corp. – Case Number C05010003**
  The firm agreed to a censure and a $25,000 fine based on NASDR’s findings that it failed to document or demonstrate that it made reasonable efforts to obtain information concerning customers’ investment objectives with respect to 12 variable annuity transactions out of 99 reviewed. NASDR further found that the firm’s written supervisory procedures concerning the sale of variable annuities were deficient in that they:

  - encouraged, but did not require, the collection and maintenance of customer investment objectives by registered representatives;
  
  - did not require supervisory review of financial status information in certain instances; and
  
  - did not require supervisory review of the suitability of the allocation of premium payments to investment portfolios or sub-accounts, in relation to customers’ investment objectives.

  It is also interesting to note that the firm executed a settlement agreement with two public customers, which included a provision requiring the customers to request the NASD to suspend its investigation of the matter which was the subject of the settlement agreement. This action constituted a violation of NASD Conduct Rule 2110.

Industry members were not forced to speculate about the meaning of these cases. The NASD’s message came through loud and clear in the press release announcing the actions: “It is extremely important that firms selling variable annuities have supervisory systems in place that...
will be able to detect if unsuitable sales are taking place.”

A few weeks later, Barry Goldsmith, head of NASDR’s Division of Enforcement, reiterated the cases’ significance: “These cases really highlight the fact that firms need to collect [suitability] information and have a supervisory system that makes sure brokers selling these products are doing appropriate suitability analysis and documenting it.”

Mary L. Schapiro, President of NASD Regulation, said, “These enforcement actions demonstrate that variable annuities, like other securities products, must be properly sold and must be suitable investments for those who purchase them. Because these are complex products both for the broker who sells them, as well as the investor who buys them, it is extremely important that firms selling variable annuities have supervisory systems in place that will be able to detect if unsuitable sales are taking place.”

The final case announced by NASDR in February 2001 was not resolved by agreement of the parties and remains pending. NASDR filed a two-count Complaint against Respondent American United Life Insurance Company, alleging violations of three NASD Conduct Rules. First, NASDR alleged that certain advertising materials distributed by the firm were misleading, in violation of Rules 2110 and 2210 (Communications with the Public), in that they:

- failed to disclose adequately that variable contracts purchased for tax-deferred plans provide no additional tax benefit to the purchaser;
- contained language that implied that tax benefits are only available in tax-deferred plans if they are funded with annuity contracts; and
- failed to disclose adequately that the investment vehicles funding the plans are variable contract sub-accounts rather than mutual funds.

NASDR further alleged that the firm violated Rules 2110 and 3010(b) by failing to establish, maintain, and enforce proper written supervisory procedures governing the review, approval, and distribution of advertising materials and sales literature in connection with its sale of variable annuity contract products.

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21 NASDR Press Release, Feb. 15, 2001, <<www.nasdr.com/news/pr2001/ne_section01_022.htm>>. The press release specifically referred to Notices to Members 99-35 and 00-44, as well as the Regulatory & Compliance Alert concerning advertising of bonus credit variable annuities, noting “[t]hese information pieces have given firms and their brokers sound guidance on how to sell variable annuity and life contracts, and also offer key points to consider when evaluating the suitability of these products for investors.”


24 American United Life Insurance Company - Case Number C0501001.
C. NASD INVESTOR ALERT

In addition to the disciplinary actions, on February 15, 2001, the NASD released an Investor Alert concerning variable annuity exchanges, titled “Should You Exchange Your Variable Annuity?” The Investor Alert can be found at <<www.nasdr.com/alert_02-01.htm>> (the “NASD Alert”) and provides insight into current NASD expectations for sales presentation disclosure and suitability considerations.

The NASD Alert focuses on replacements, warning that “[g]enerally, the exchange or replacement of insurance or annuity contracts is not a good idea, for a variety of reasons.”

Some of the reasons identified in the NASD Alert include:

- New charges may be imposed with a new contract, or may increase the period of time for which a surrender charge applies;
- Charges may be higher under the new contract;
- The costly features of the new contract may not be needed; and
- The sales representative is getting paid a higher commission for a variable annuity sale than for the sale of another security or investment.

The NASD Alert also outlines five questions that an investor should ask when considering a registered representative’s recommendation to exchange a variable annuity:

- What is the total cost to the investor of the exchange?
- What does the change in the surrender period or other terms mean for the investor?
- What are the new features being offered and why does the investor want or need them?
- Are those features worth the increased cost?
- Will the registered representative be paid a commission for the exchange and, if so, how much is it?

Use of Disclosure Document. Like the SEC Alert “Variable Annuities: What You Should Know,” issued in June 2000, the NASD Alert focuses on disclosure issues for investors. While the VA Notice appeared to suggest that state replacement forms may provide relevant discussion, the two alerts are more specific about what disclosure should be provided. This disclosure appears more extensive than what would be required under state replacement regulations.

25 In June 2000, the SEC unveiled this online brochure to help investors better understand the benefits, risks, and costs of variable annuities.
Document the Basis for the Exchange. Since the NASD Alert cautions investors not to sign an exchange form or agree to an exchange until all questions are answered, firms that cannot provide evidence of addressing these concerns may not be able to support the sales.

Best Interests Standard. The “best interests” standard was articulated in the VLI Notice II for life insurance replacements and in the NASD Alert for annuity replacements. A “best interests” standard appears to be a higher standard than a “suitable” standard.

V. NASDR AND SEC SWEEPS EXPECTED TO CONTINUE

The NASDR and SEC’s examinations will continue to focus on the sales and marketing activities of agents and the supervision they receive in the sale of variable products.

A. Suitability and Supervisory Procedures

NASDR is expected to continue to focus on the selling firm’s suitability and supervisory procedures. Although the sanctions and the size of the fines imposed in five of the six cases brought in February 2001 were relatively mild, particularly in light of the size of the firms involved, the penalties are expected to increase. After the six disciplinary actions were brought, Mr. Goldsmith explained that the penalties reflected the firms' promptness in taking steps to address problems and improve monitoring systems.26 Mr. Goldsmith warned, however, that NASDR was unlikely to be so lenient in the future: “We certainly do have other cases that may warrant stiffer sanctions, but those are still being completed and have not been resolved at this time. . . . This has been sort of the first tranche of cases. We hope these firms take corrective actions, and others avoid some of the problems we saw here.”27

Exhibit 1 is a sample of the documents and information requested by the NASDR during its second “sweep.” The NASDR requests document lists cover a broad array of matters: advertising and sales literature, firm audits, information about individual customers who participated in 1035 exchanges, complaints and exception reports.

B. Bonus Annuities

One area of particular concern to the SEC is the sale of bonus annuities. Mr. Roye addressed replacement practices involving bonus annuities in a speech delivered at the Practicing Law Institute Conference in January 2001. After articulating concerns with bonus annuities generally, Mr. Roye noted that: “[O]ur concerns are heightened in cases when a bonus is paid to an investor transferring funds from one variable annuity to another in an exchange. Often in these cases an investor at or near the end of a surrender charge period takes on a new surrender charge schedule as a result of the exchange. Depending on the time horizon for the new

27 Id.
investment, the impact of the new surrender charge could outweigh the value of the bonus. You can expect us to continue to comment on any presentation of a bonus product that does not fully and fairly disclose the downside, as well as the upside, of the product.”

Exhibit 2 is a sample of the documents and information requested by the NASDR regarding “bonus variable annuities” and “dollar cost averaging programs.”

C. Retail Exception for Replacements

In June 2001, Susan Nash, the Associate Director of the SEC’s Division of Investment Management, issued a letter to several industry organizations, explaining the Division’s view of the “retail exception” under Section 11 of the Investment Company Act of 1940 when variable contracts issued by an insurer are exchanged for other contracts issued by the same insurer. In the letter, Nash expressed “concern that some insurers may be interpreting the ‘retail exception’ too broadly.” Insurers can expect the SEC to scrutinize the industry’s use of the retail exception.

D. 1035 Exchanges

In June 2001, Paul F. Roye, reiterated that the high level of exchange activity in the variable annuity market was a concern for the staff. Mr. Roye said:

estimates suggest that as much as 40% of new sales of variable annuities are attributable to contract exchanges. Ten years ago only 8% of sales came from exchanges. Many of these sales are exchanges for so-called “bonus” annuities, which offer the investor an immediate credit equal to a percentage of purchase payments, and often involve higher contract expenses. This high level of exchange activity commands increased vigilance by the staff.

VI. RED FLAGS INDICATING A WEAK SUPERVISORY SYSTEM

The message of the six NASDR disciplinary actions and the SEC enforcement action could not be any clearer. Firms that sell variable products must establish, maintain, and enforce written supervisory procedures that:

- require registered representatives to analyze the suitability of all variable annuity sales and exchanges based on adequate information;

30 Id.
• require registered principals to review variable annuity sales and exchanges for suitability; and

• require documentation of all suitability reviews.

In light of the specific guidance given on this subject in recent years, it should come as no surprise that the SEC “is not sympathetic in problematic situations when firms either have no compliance procedures or have compliance procedures but do not implement them.”

In fact, in November 2000, Paul Roye commented, “you can expect that the Commission’s examination program will continue to focus on the sales and marketing activities of agents and the supervision they receive in the sale of variable products. The inspections staff looks to see if appropriate systems are in place to ensure that agents are asking the right questions to determine suitability of a variable insurance product, and whether those systems are working.”

There are numerous supervisory practices that raise “red flags” indicating the affiliated broker-dealer does not have a supervisory system in place that would stand up to an investigation by the securities regulators. Those are:

• **Incomplete Customer Information Files**
  
  o Supervisors and compliance departments cannot make suitability determinations if the registered representative has not provided the required information.

  o The broker-dealer must develop, maintain and update complete records on the customer.

  o Registered representatives should recommend only products and product features that fit the customer profile.

• **Inadequate Written Procedures**

  o The broker-dealer must develop, maintain and update detailed written supervisory procedures and procedures explaining the registered representative’s duties and responsibilities.


32 Id.
It is not enough for the procedures to exist. Supervisors and registered representatives must understand what is expected of them by the NASD conduct rules and the firm.

- **Lack of One-on-One Supervision**
  - Each registered representative must report to a designated supervisor who is identified in writing.

- **Unclear Suitability Review Process**
  - The home office should develop and maintain records of the registered representative’s suitability rationale and the supervisor’s review and approval or denial of the transaction.

- **No Documentation of Ingoing-Outgoing Mail Review**
  - Supervisors are required to review and sign off on the registered representative’s incoming and outgoing mail. Specifically, the supervisor should be looking for inappropriate sales and marketing pitches and other misrepresentations and complaints.

- **Knowledge of 1035 Exchanges**
  - The home office should be in a position to report the number of and percentage of 1035 exchanges.

- **Management Exception Reports**
  - The home office should have regularly scheduled management exception reports to show activity such as 1035 exchanges, multiple sales of products to one customer, or sales of products to customers by income or age.

  - Members of the compliance staff should be designated in writing to review scheduled management exception reports and follow up on corrective action.

- **Lack of Communication Between Offices**
  - The home office should communicate problems raised in exception reports to the Branch Office Manager for possible corrective action or heightened supervision.
• **Inspection of Offices**
  
  o The firm should have a rigorous internal audit program and conduct on-site inspections with surprise visits.

• **Disciplinary Policy**
  
  o The firm should have a strong disciplinary action policy that is documented and acted upon immediately.

  o The firm should have procedures for conducting heightened supervision.

• **Training Programs**
  
  o The firm should have a training program that reinforces NASD rules and explains the product.

• **Product Review**
  
  o The firm should ensure that the current prospectus is provided at point of sale. All product marketing and training materials should be reviewed for consistency with product profile.

VII. **CONCLUSION**

While the variable insurance industry has changed in terms of products, distribution channels, and sales and regulatory scrutiny, there is one fact that the variable insurance industry can rely upon in this changing world: the securities regulators are not going away. Affiliated broker-dealers face greater sanctions for violative conduct as the SEC and NASDR continue to scrutinize closely the supervision of sales and the suitability of sales of variable products. Insurance companies must strongly consider taking proactive measures to meet the securities regulators’ expectations regarding variable products.