

The SEC and NASD Issue a Joint Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products; the NASD Proposes a Variable Annuity Sales Practice Rule

The Securities and Exchange Commission ("SEC") and the National Association of Securities Dealers ("NASD") recently issued a joint staff report on the findings of their examination of broker-dealer sales of variable insurance products.¹ At the same time, the NASD proposed a new rule tailored specifically to address sales of deferred variable annuities.² Both the report and the proposed rule arrive at a time when firms involved in sales of variable insurance products face increasing regulatory scrutiny and enforcement actions.³

SEC/NASD Joint Report

The report's findings focus on sales practices in several key areas, including: suitability, sales practices, and conflicts; supervision; disclosure;

books and records; and training. The report identifies weaknesses and "sound" sales practices in the key areas.⁴ The obvious message is that broker-dealers need to employ sound practices in selling variable products.

Suitability, Sales Practices, and Conflicts

The report reviewed broker-dealer sales practices involving variable product recommendations to customers.⁵ The examination considered suitability practices in terms of product recommendations, switching or replacements,

¹ See Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products available at <http://www.sec.gov/news/studies/secnasdvip.pdf> ("SEC/NASD Joint Report").

² See NASD Notice to Members 04-45, NASD Seeks Comment on Proposed Rule to Impose Specific Sales Practice Standards and Supervisory Requirements on Members for Transactions in Deferred Variable Annuities (June 2004).

³ See NASD News Release, NASD Disciplines Three Firms, Three Brokers for Variable Annuity Abuses (May 20, 2004) available at http://www.nasdr.com/news/pr2004/release_04_034.html.

⁴ This Client Memorandum presents a summary of the sales business practices identified in the SEC/NASD Joint Report. For the full details and the extended list of sales practices, see the report.

⁵ Federal securities laws and rules of self-regulatory organizations require that a broker-dealer must have reasonable grounds for believing that the recommendation is suitable for a customer based upon certain facts. A broker-dealer must make reasonable efforts to obtain information about the customer, such as customer information relating to financial status, tax status, risk tolerance, and investment objectives, to assist in the analysis of whether the variable product is a suitable investment. See, e.g., NASD Conduct Rule 2310 and IM 2310-3. Suitability liability may also arise under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 ("1934 Act").

policies and procedures, and supervisory reviews. Some weaknesses in firms' suitability practices identified in the report were:⁶

- Broker-dealers made unsuitable variable product recommendations without a reasonable basis despite customer information that was available to make a suitability determination;
- Examiners found unsuitable switching or variable product replacements. Registered representatives gave "false and misleading justifications" for switches and replacements;
- Procedures did not require documentation of the suitability analysis or that registered representatives collect all information required to conduct a suitability analysis; and
- Some firms did not require supervisors to review the suitability of recommendations or sales.

The examiners identified, among others, the following sound practices regarding suitability:

- Firms required registered representatives to document each sale with a suitability checklist that evidenced the suitability determination;
- Suitability determinations were made on two levels—the contract level and the underlying fund level;
- Firms implemented procedures to screen for specific suitability issues and to prevent unsuitable sales of variable annuities in an IRA, 401(k), or other tax-qualified accounts; and
- Firms implemented an automated system to facilitate a comparison of sales recommendations, including the underlying funds, to the client's suitability profile to ensure that sales were consistent with the client's investment objectives and risk tolerance.

⁶ In each instance, this memo reflects only a handful of the weaknesses and sound practices identified in the report. The report cited many more.

Supervision

The report identified inadequacies and sound practices regarding supervision by broker-dealers of their employees and associated persons in variable product sales.⁷ Inadequacies regarding supervision noted in the report were:

- Written supervisory procedures did not adequately address a firm's variable product business, nor were the procedures updated to address a firm's growing variable product business;
- Customer files lacked evidence of supervisory review and approval, such as a principal's signature on new account forms, order tickets, and other documents that require supervisory review and approval; and
- Firms did not employ systems to ensure enforcement of their written supervisory procedures and did not monitor variable product sales activities of registered representatives through use of exception reports.⁸

Sound business practices identified by the examiners include:

- Supervision in which, among other things, supervisors reviewed every sale of a variable product to ensure that it was appropriate and hypothetical illustrations to ensure assumed rates of return were indicative of current markets and reflective of appropriate assumptions; and
- Implementation of automated systems that could detect and prevent improper replacement sales of variable insurance products, and that could produce comprehensive and tailored exception reports, which identified potential problems involving sales of variable products.

⁷ Section 15(b)(4)(E) of the 1934 Act grants the SEC authority to sanction broker-dealers for failure to supervise. See *also*, NASD Conduct Rule 3010.

⁸ Exception reports could assist supervisors to discover sales practice problems, such as excessive switching, unauthorized trading, or other red flags. The SEC/NASD Joint Report included examples of relevant exception reports in an appendix to the report.

Disclosure

The report noted weaknesses where firms failed to provide certain disclosures to customers in connection with sales of variable products, among them:⁹

- Firms failed to disclose variable contract fees, risks associated with investment in the product, and the lack of liquidity of variable products;
- Firms failed to disclose the tax implications of investing in variable products;
- Firms failed to disclose the potential consequences of financing a variable product, such as the interest rate risk associated with any variable rate loan, that borrowing against cash value in an existing policy or annuity will deplete the cash value, and that a new policy will lapse if premiums are not paid; and
- Examiners found undisclosed conflicts of interest. For example, investment advisers were recommended for asset allocation services with wrap or managed account programs based on affiliations with or expected payments to broker-dealers, which were not disclosed.

Sound business disclosure practices identified in the report were:

- Firms made specific disclosures about fees, risks, and tax implications;¹⁰
- Customers were directed to information about investment in variable products located on the SEC and NASD websites; and

⁹ See, e.g., Section 5(b)(2) of the Securities Act of 1933 (“1933 Act”). The NASD, through various Notices to Members, has provided guidance to broker-dealers regarding disclosures made to customers who invest in variable products. See NASD Notice to Members 96-86, NASD Regulation Reminds Members and Associated Persons that Sales of Variable Contracts are Subject to NASD Suitability Requirements (December 1996); NASD Notice to Members 99-35, NASD Reminds Members of Their Responsibilities Regarding the Sales of Variable Annuities (May 1999); and NASD Notice to Members 00-44, The NASD Reminds Members of Their Responsibilities Regarding the Sale of Variable Life Insurance (July 2000).

¹⁰ We have noticed a growing trend that the NASD is applying a strict mathematical standard to the determination of whether one product or class from the same issuer is more suitable for the customer than another based strictly on the cost or rate of return. The regulator then tends to presume that selling the customer the more expensive product is not suitable, and it can be difficult to overcome that presumption.

- Firms used a form to disclose to customers in full, clear, and balanced terms the features, benefits, fees, risks, surrender periods, and financing risks of variable product transactions.

Books and Records

The report noted weaknesses in broker-dealers making and keeping certain records and obtaining current information about their customers.¹¹ Weaknesses noted in the report include:

- Customer information that was required for a suitability analysis was missing from customer files;
- Documents related to an exchange or replacement analysis did not include an explanation about the benefits of replacing one policy with another, did not document the reasons for the replacement, or did not require the customer’s signature; and
- There was little or no documentation of disclosure to customers about variable product fees, risks, or expenses.

Sound books and records business practices identified in the report were:

- Firms obtained updated client information on a regular basis;
- Firms maintained a new account form on file for each customer, along with the application or order forms for each transaction;
- Firms used forms to document the customer’s reason for switching that required the customer to write the reason and then sign the form; and
- Firms maintained full and complete documentation of written disclosures made to customers.

Training

The report states that because variable products are complex investment vehicles, broker-dealers should ensure that employees and associated persons have

¹¹ See, e.g., Rules 17a-3 and 17a-4 of the 1934 Act. Rules of self-regulatory organizations also create books and records obligations for broker-dealers. See, e.g., NASD Conduct Rule 3110. Examples of records that a broker-dealer must create and maintain include purchase and sales blotters, order tickets, and customer account information.

adequate training to carry out their responsibilities regarding variable product sales. Identified weaknesses were:

- Firms' training programs did not cover the sale or supervision of variable products;
- Firms that provided some training did not address special features or specific suitability issues of variable products; and
- Supervisors were not adequately trained to identify abusive sales practices.

The report noted the following sound business practices regarding training:

- The training program effectively addressed variable product sales and the responsibilities regarding the suitability analysis (including a description of how the analysis should be done), and prepared registered representatives to carry out their responsibilities regarding sales activities; and
- Supervisors received special training to assist them with identifying sales problems.

NASD Proposed Rule to Impose Specific Sales Practice Standards and Supervisory Requirements on Members for Transactions in Deferred Variable Annuities

The NASD's proposed rule is of major consequence in that, if adopted as proposed, it would establish new standards with respect to the sale of deferred variable annuities. The following represents the proposed new requirements, which have the potential of establishing significant new broker-dealer responsibilities:

1. The proposed rule would require members to provide, in addition to a current prospectus, a separate "easy to read risk disclosure document."¹² This new document would include information as to: surrender charges, the IRS penalty on early withdrawals, sales charges, fees (e.g., mortality and expense charges and administrative fees), information as to federal and state tax treatment of variable annuities, whether a "free look" period applies, and "market risk."

¹² Unlike a prospectus, which is the responsibility of the issuer of a security, this disclosure requirement would be the responsibility of the selling broker-dealer "to provide" to the customer.

2. A registered principal, no later than one business day following the date of the application, would be required to review and to approve the transaction. The registered principal would need to take into account, among other things, whether:
 - (i) the customer's age or liquidity needs make a long-term investment inappropriate, such as a customer over a specific age or with a short-term investment objective;
 - (ii) the amount of money invested exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount;
 - (iii) the transaction involves an exchange or replacement of a deferred variable annuity contract;
 - (iv) the customer's account has a particularly high rate of deferred variable annuity exchanges or replacements;
 - (v) the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges or replacements; and
 - (vi) the purchase of the deferred variable annuity is for a tax-qualified retirement account (e.g., a 401(k) plan or IRA).
3. In addition, when the transaction involves an exchange or replacement, a registered principal would need to review and approve a separate exchange or replacement document, which would cover issues specific to exchanges or replacements. This separate replacement document would be in addition to the "risk disclosure document" discussed above.
4. The proposed rule would also impose an obligation that the "deferred variable annuity as a whole and the underlying subaccounts are suitable for the particular customer."

The NASD is soliciting comments on its proposed rule by August 9, 2004.

Practice group contacts

If you have questions regarding the information in this update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/financialservices.

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