Disclosure & Agent Responsibilities

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Annuities at their most basic level are a simple concept to grasp — but as the old saying goes: the devil is in the details. Each contract has its own the unique set of provisions, which complicates the advisor's task of recommending suitable contracts for his or her client's unique situation. As a result, many clients have been sold annuity contracts that do not meet their needs. Over the years, the annuity industry has developed new, more complicated types of contracts (EIAs, for example) and introduced new benefits that are not easily understood (such as enhanced living and death benefits). Government regulators at the state and federal level have noted this growth and its adverse impact on clients. As a result, they have imposed additional regulations on the sale of annuities. The purpose of these enhanced regulations is to protect consumers and aid advisors in their search for suitable investment recommendation. This chapter will explore two of these regulations: Florida's Senior Consumer Law and FINRA's Suitability Disclosures. These regulations, to some extent, overlap each other, but may not apply to every situation. Ethical advisors will want to follow the general principles of these regulations regardless of whether the strict language of the rules applies to a particular situation or not.

Regulatory Framework

Before we explore these two regulations, a brief review of the regulatory framework and conflicting jurisdictions governing annuities is in order. Fixed annuities, including equity indexed annuities, fall under the purview of state insurance authorities. Variable contracts fall under both state and federal jurisdictions — state insurance commissioners regulate the variable contract itself as an insurance product, the SEC claims jurisdiction over the separate, subaccounts within the contract as an investment product. The SEC, in turn, delegates oversight of the sale of variable annuities to FINRA (Financial Industry Regulatory Authority). As a result, state laws govern the sale of fixed annuities (and to some extent, variable annuities); FINRA governs the sale of variable annuities only. Please note: one of the federal requirements imposed on separate investment accounts is that they be registered under the Securities Act of 1933 and the Investment Company Act of 1940 (the same requirement that applies to mutual funds). Insurance products, such as fixed annuities need not register with the SEC. In the parlance of federal regulations, fixed annuities are referred to as "nonregistered" securities. This does not mean that fixed annuities are unregulated. Fixed annuity contracts will be filed with state regulators, so the federal authorities' use of the term "nonregistered" can be a bit misleading to the casual reader.

The SEC has proposed that equity indexed annuities be treated as variable contracts, and therefore brought under their jurisdiction. That proposal has met with significant opposition by the National Association of Insurance Commissioners, or NAIC (who wish to preserve state regulations) and the annuity industry (which finds state regulation less binding). There are valid arguments on both sides of this question — and the ultimate outcome of the SEC proposal will eventually be settled in the political arena. Until such time as the status of EIAs is changed, assume that our discussion of fixed annuities includes EIAs as well.

Florida's Senior Consumer Law

In the late 1990s, state regulators across the country began to seriously address the sale of fixed annuities to "senior consumers". These laws typically required advisors to make minimum inquiries of their older client as to their financial situation and needs. Florida enacted these consumer protections, based on the NAIC's "Senior Protection in Annuity Transactions Model Law", in 2004. Analysis by the Department of Financial Services found that due to vague wording this law was ineffective. In 2008, the Florida legislature strengthened its language. This was in response to instances in which elderly clients were sold annuities that were deemed unsuitable for their needs — in particular, highly-illiquid contracts. One elderly couple from Venice, both in their eighties, were sold $600,000 in annuities with surrender charge periods that lasted longer than their life expectancies. The updated and strengthen state law, known as the "John and Patricia Seibel Act" is named for them. The Seibel Act contains several important features:

Senior Suitability

The initial NAIC model enacted in Florida was intended to create standards for recommending the purchase or exchange of annuities to consumers who are 65 or older, specifically that agents and insurers must have "reasonable grounds" for recommending annuities to seniors. The intent of the Seibel Act is to replace this subjective standard with a more objective standard. The initial law was ineffective because regulators needed clear and convincing evidence, not to prove that a particular transaction was indeed suitable for the client, but whether the agent reasonably believed it was. The new standard now requires an insurer or agent, who recommends purchase or exchange of an annuity to a senior consumer, to have "an objectively reasonable basis for believing the recommendation is suitable." A "senior consumer" is defined as an individual purchaser age 65 or older — and the case of joint purchasers, if either is 65 or older. A "recommendation" is a transaction that is based on the agent's advice.

Disclosure requirements

The Seibel Act specifies the minimum information that must be obtained from the consumer and requires use of a form designed by the Department of Financial Services. At a minimum, agents must ascertain the client's:

- age and gender of the purchaser(s),
- number and age of any dependents,
- investment objectives,
- risk tolerance,
- existing assets,
- annual income,
- tax status,
- liquid net worth,
- future financial concerns and needs (medical expenses, long-term care, bequests to heirs, projected retirement age, etc.),
- intended use for the annuity, and
- source of funds to be invested in the annuity.

The agent must also note any other information he or she used or considered in making the recommendation.

The agent must forward a copy of the completed questionnaire to the issuing company (or its authorized third party, such as a managing general agent or insurance agency) within 10 days. A copy of the completed questionnaire must be given to the client no later than the time the contract documents are delivered to the client.

Any recommendations given by the agent must be suitable based on the information the client provides to the agent at the time of purchase. The agent is absolved of the suitability requirements if the client refuses to give the agent the required information, the client provides false or incomplete information, or the client chooses to purchase annuities against the recommendation of the agent. If the client refuses to provide the required information, the agent or insurer must, before execution of a transaction, document the client's refusal on a form approved by the Department — and obtain the client's signature. This form will disclose to the client that failure to provide the required information may limit the protections offered under this law.

If the client currently holds one or more annuity contract, the agent must also determine:

- the type of contract(s) the client holds,
- the issue dates(s),
- maturity or annuitization date(s),
- allocation of funds within the contract (for variable annuities),
- applicable surrender charges,
- any contract riders or endorsements, and
- liquidity within the contract(s) — prior to maturity and at maturity.

If the agent recommends a transaction to replace or exchange an annuity, the insurer or agent must provide a written comparison of the existing contract and the proposed contract, on an approved form. This disclosure form will compare:

- the benefits, terms, and limitations between the annuity contracts,
- any fees and charges between the annuity contracts.

This replacement form must also contain a statement by the agent describing the basis for recommending the exchange, including the overall advantages and disadvantages to the consumer if the recommendation is followed. The agent must also disclose other information used or considered to be relevant by the insurance agent or the insurer in making his or her recommendation to replace the annuity contract.

As with the basic questionnaire, a copy of the replacement comparison form must be forwarded to the proposed issuing company within 10 days, and to the client no later than delivery of the contract documents.

Agents who recommend the purchase of an annuity or propose to replace an annuity must disclose to the client that such actions may have tax consequences and that the applicant should contact his or her tax advisor for more information. The law does not require that this disclosure be in writing, or on any particular form, but cautious agents will want to permanently document this disclosure.

Supervision

Agents, insurance agencies and issuing companies must put in place systems to assure agents make suitable recommendations and comply with this law. At a minimum, this requires a set of written procedures and periodic audits to assure compliance. Often, issuing companies will contract with third parties — such as managing agents or insurance agencies — to market their annuity products. Issuers can also rely on these third parties to implement appropriate supervisory systems on their behalf to assure that agents under the third party's control follow the law when selling the issuer's products. When issuing companies rely on third parties to fulfill this compliance role, the issuing company must make adequate inquiries into the third party's supervisory efforts and take whatever actions are necessary to assure that the third party is adequately meeting its compliance function. Issuing companies may meet this obligation by periodically auditing third parties who represent the company, or obtaining an annual statement from the senior manager of the third party that the third party is continuing to fulfill its supervisory role. When requested by the issuing company, managers of third parties must promptly provide a certification of continued compliance (or statement of non-compliance, if that is the case). Industry groups have formed voluntary certification systems for third party supervisors. Issuing companies and managing agents are only required to monitor agent compliance with the suitability requirements for products offered by that company or agency — they have no supervisory responsibility for products offered by other companies or agencies.

The law mandates that certain documents be retained for at least five years. The law simply states that issuing companies, agents, and third parties retain "records of the information collected from the senior consumer and other information used in making the recommendations" — this would include annuity applications, questionnaires, illustrations, customer correspondence, account review documents and account statements

The prior law was vague as to who — agents, companies or third parties — must retain supporting documentation. The new law places the responsibility on all three. The annuity company can offer (but is not required) to maintain these records on behalf of its agents. Original records may be retained, or the records can be kept in any other media (photographic, digital, etc.) so long as a legible reproduction of the original is maintained.

Mitigation

One particularly important amendment to the new suitability law gives the Department of Financial Services (which regulates agents) and the Office of Insurance Regulation (which regulates insurers) the power to correct, or "mitigate" unsuitable annuity purchases. The Office of Insurance Regulation can force an issuing company to rescind inappropriate contracts — in effect, canceling the contract and refunding the client's money. The amount of the refund is the greater of the client's investment or the accumulated value in the contract. The Department of Financial Services may take "any reasonably appropriate corrective action" to undo harm to a senior client by an agent's recommendations. The law also allows regulators to waive penalties for companies and agents that take prompt actions to correct harm caused by unsuitable recommendations. (The offer to waive penalties is an incentive to get companies and agents to "do the right thing" to make the client whole.)

This new power to rescind annuity contracts is quite broad. Other regulators in the state may pursue rescissions through the court system, but the unilateral power of the OIR to rescind contracts is unprecedented in Florida.

Agents or insurers who fail to meet the requirements of this law are subject to penalties and enforcement action by the Department of Financial Services or Office of Insurance Regulation. This law does not give clients or others the right to sue privately for violations of these rules — although clients may pursue other claims such as breach of fiduciary trust or negligence in private, civil legal proceedings.

The updated law includes a new provision to protect issuing companies from actions taken by unrelated, unauthorized parties:

> "Nothing in this section shall subject an insurer to criminal or civil liability for the acts of independent individuals not affiliated with that insurer for selling its products, when such sales are made in a way not authorized by the insurer."

Scope

Generally speaking the new disclosure requirements apply to the sale of annuities to individual, senior customers (age 65 or older). The law specifically exempts certain transactions from these requirements:

- sales resulting from direct mail solicitation in which no recommendation is made by the agent, or
- contracts sold to an employer's qualified retirement plan (plans covered by ERISA, 401(k) plans, etc.), tax-sheltered annuities sold to non-profit organizations and church plans (403(b) plans), or government-provided retirement plans (457 plans), and
- sales to employer-provided non-qualified deferred compensation plans.

Note that annuities sold to Individual Retirement Accounts must follow the suitability requirements for that individual — if the individual is age 65 or older.

FINRA Exception

One odd legislative note about the updated law: The prior state statute carved out an exception to the suitability rules for sales of variable annuities by agents who were affiliated with broker-dealers regulated by the NASD. All agents selling variable annuities needed to be registered as a representative of a broker-dealer that belonged to the NASD — so this exception effectively put sales of all variable annuities outside the scope of this state law. The premise for that exception was that the NASD had its own suitability requirements, and the state was simply deferring to the NASD's requirements for the sale of variable annuities.

In the legislature's infinite wisdom, when they updated the language in 2008, they extended this exception to cover the sale of any annuity (fixed or variable) by a FINRA affiliated agent. While

FINRA (NASD's successor) has suitability rules for the sale of variable annuities, it has no jurisdiction over fixed annuities (including indexed annuities). This leaves a possible loophole for the sale of fixed annuities by FINRA affiliated agents. It is possible to read the new law in such a way as to exempt any FINRA affiliated agents from compliance with this law:

> "Any person who is registered with a member of the Financial Industry Regulatory Authority, who is required to make a suitability determination, and who makes and documents such determination is deemed to satisfy the requirements under this section for the recommendation of annuities. "

The key phrase is: "who is required to make a suitability determination". FINRA representatives are, generally speaking, prohibited from making unsuitable recommendations. Is that general principle the same as making a "suitability determination"? If it is, then FINRA affiliated reps need not follow the new state suitability rules when selling any type of annuity. If one argues that FINRA has no jurisdiction over fixed annuities and therefore it cannot require a suitability determination for sales of fixed annuities — this exception then applies only to variable annuities, and state law applies to the sale of fixed annuities at FINRA institutions. (This was the original law's language and probably the legislature's intent when it updated the language.) It is interesting to note, however, that the title of this exception was changed too — from "Application to Variable Annuities" to "Application to Annuities" — so perhaps the legislature intended to expand this exemption to the sale of all annuities by FINRA reps after all.

State regulators jealously guard their jurisdiction. Cautious agents affiliated with FINRA broker-dealers would be wise to follow the original law's intent — apply FINRA rules to the sales of variable annuities and comply with state suitability requirements when it comes to recommendations of fixed annuities (including EIAs).

Other Provisions

The Senior Suitability provisions were the primary focus of the 2008 update, but there were a number of other important amendments included in the Seibel Act. These provide additional protections to the general insurance-buying public, not just "senior consumers".

Buyers Guides & Contract Summaries

Sales of life insurance policies require the delivery of some standard disclosure documents: the Buyer's Guide and a Policy Summary. Both of these are drawn up in accordance with NAIC guidelines. In the case of fixed annuities, state law mandated the delivery of a Buyer's Guide and a Contract Summary. Under prior state law, these documents were not required in the sale of variable annuities. (A prospectus, a federal disclosure requirement, must accompany the sale of variable annuities.)

The Seibel Act now requires a Buyer's Guide and Contract Summary for the sale of all annuity contracts — fixed, variable or indexed. (Sales of variable annuities must still be accompanied by a prospectus.)

Free Look

Prior to the Seibel Act, state law mandated a 10-day "Free Look" period for the sale of all life insurance products and fixed annuity contracts. The "free look" provision is designed to give purchasers an opportunity to review the terms of the contract — and if they choose, to return the contract within the first ten days for a full refund on the premiums. Issuers could avoid the "free look" refund provision by giving the prospective purchaser a Buyer's Guide and Policy Summary (for life insurance)/Contract Summary (for annuities) ten days prior to purchase. But if these documents are delivered at the time of purchase — as they usually are — the contract must include the refund provision.

The Seibel Act extends the "Free Look" period from 10 days to 14 days. The Act also broadens the Free Look refund provision to include variable, as well as fixed, annuities.

Indirect Churning

Florida law prohibits both "twisting" and "churning". Both practices rely on misrepresentations, and therefore are considered unethical. Twisting is the replacement of one insurance product for another issued by a different company, based on false or misleading information with the agent's intent to earn a commission. Churning is sometimes called "internal twisting": the client is induced to exchange one company's product for another product issued by that same company. A related, prohibited practice, is known as "stripping" — in which the cash value in one insurance product is used to finance the purchase of another insurance product (again, based on misrepresentations).

The Seibel Act modifies the definition of “churning" to cover direct or indirect churning. Indirect churning occurs when a policy is surrendered and the resulting funds are used to purchase an immediate annuity (specifying payments to begin at once) which is then used to fund a deferred annuity or a life insurance policy. It is often done because the agent can receive a double commission for the immediate annuity and the deferred annuity or life insurance policy that it funds.

Fraudulent Signatures / Forgeries

One commonly used type of insurance fraud involves forged signatures on applications and other documents.

The Seibel Act creates a new prohibited act and makes it a third degree felony to willfully submit to an insurer an insurance application or policy-related document on behalf of a consumer that contains a false or fraudulent signature.

Unlawful designations or credentials

Another type of misrepresentation occurs when agents use credentials to mislead prospects into thinking the agent is more experienced and knowledgeable than is indeed the case. There are a number of organizations that, for a fee, will simply hand out credentials and official-looking designations to bolster the agent's resumé.

The Seibel Act prohibits the agents from using designations or misrepresenting the agent qualifications:

- ♦ When making a sales presentation or solicitation for insurance, an agent is prohibited from utilizing designations or titles that falsely imply that he or she has special financial knowledge or has obtained specialized financial training or is certified or qualified to provide specialized financial advice to senior citizens.
- ♦ Terms such as "financial advisor" may not be used to falsely imply that an agent is licensed or qualified to discuss, sell, or recommend financial products other than insurance products.
- ♦ When making a sales presentation or solicitation for insurance, an agent is prohibited from falsely implying he or she is qualified to discuss, recommend, or sell securities or other investment products in addition to insurance products.

The law makes exceptions for bona fide credentials. An agent who also holds a designation as a certified financial planner (CFP), chartered life underwriter (CLU), chartered financial consultant (ChFC), life underwriter training council fellow (LUTC), or the appropriate license to sell securities from the Financial Industry Regulatory Authority (FINRA) may inform the customer of those licenses or designations and make recommendations in accordance with those licenses or designations.

Enhanced Penalties

Prior to the passage of the Seibel Act, those violating the "Unfair Insurance Trade Practices Act" (which include twisting and churning) could be fined for up to $2,500 for each non-willful violation up to an aggregate $10,000 fine. Willful violations could result in fines up to $20,000 for each willful violation up to an aggregate $100,000 fine. Willful violations of these provisions was also subject to criminal prosecution as a second-degree misdemeanor

The Seibel Act increases the penalties for agents or insurers who engage in certain unfair trade practices, such as twisting, churning (directly or indirectly), deceptive use of credentials or fraudulent signatures. Violations of these rules are now punishable with a $5,000 fine for non-willful violations up to an aggregate of $50,000. Willful violations could result in fines up to $50,000 per incident, up to an aggregate $250,000 fine. Willful violations of the twisting, churning or misleading use of credentials are also subject to criminal prosecution as a first-degree misdemeanor. Willfully submitting fraudulent signatures on policy-related documents is a third-degree felony.

And as noted above, the Seibel Act also gives the Office of Insurance Regulation the power to rescind unsuitable contracts — which may impose additional financial losses on companies. Likewise, the Department of Financial Services may take reasonable corrective action against agents for harm their unsuitable recommendations cause clients. While technically not "penalties" — the mitigation provision should act as additional disincentive for unsuitable recommendations.

Agent Education

Compliance with Florida's continuing education requirements is a necessary condition for the issuance and renewal of any appointment to represent an authorized insurer. In general, life or health agents must complete at least 24 credits (hours) of continuing education every two years. Agents licensed for a period of six or more years must complete only 20 credits every two years, but these credits must be in intermediate or advanced level courses as approved by the Department. Since 2005, Florida has required life and health insurance agents, as part of their CE requirement, to complete a minimum of three credits of continuing education on the subject of "ethics".

Under the Seibel Act, for compliance periods beginning in January 2009 any agents licensed to sell annuities — that is, all Florida life-licensed agents — must complete at least three credits in the subject of "suitability". [This course meets that suitability requirement.] Credits earned to meet the "suitability" requirement may be used to meet the "ethics" requirement (but not vice versa).

Agent Email & Phone Number

The Seibel Act requires all Florida-licensed insurance agents to provide the Department of Financial Services with their email address, home phone and business phone numbers. If the agent changes any of these, he or she must notify the Department of the change within 60 days. Failure to do so could result in a $500 fine. (These are the same rules that apply to notifying the Department of changes in the agent's home, mailing or business address.) Changes can be filed electronically with the Department at its website: www.fldfs.com.

NAIC and Annuity Suitability

The National Association of Insurance Commissioners works to promote standardized state regulations nationwide. It does this by drafting "model laws" that can be the basis of actual legislation adopted by the states. Much of Florida's Insurance Code is based, at least in part, on NAIC model laws. Annuity suitability is no exception. The NAIC's initial efforts regarding annuity suitability were aimed at protecting older consumers — and the first NAIC model law on suitability, *Senior Protection in Annuity Transactions Model Regulation*, was adopted by the NAIC in 2003. This model law covers the sales of annuities to consumers aged 65 and older. Florida's initial suitability legislation in 2005 was based on that model law. Other states have pursued other forms of investor protections — some states extended the annuity protections to consumers of all ages, others extended suitability provisions to the sale of annuity and non-annuity insurance products, other states followed a model law drafted by the North American Securities Administrators Association (NASAA).

In 2006, the NAIC drafted and approved a new model law, *Suitability in Annuity Transactions Model Regulation* that extends suitability protections to sales of annuities to consumers of all ages. When Florida updated its original suitability law in 2008, it faced a choice — and the Legislature chose to continue to apply the suitability requirements only to the sale of annuities to senior consumers. With intense focus on this issue, it is quite possible that Florida, in the future, will join other states that expand that requirement to the sale of annuities to all consumers. There certainly is nothing unethical if a Florida agent wishes to apply the senior rules to younger clients — even if Florida law does not require it. The disclosure requirements in Florida's senior law offer agents a convenient checklist of questions to ask prospects of any age before making a fixed annuity recommendation. As we'll see in the next section, FINRA's requirements make no distinction based on age when it comes to recommendations for variable annuities. FINRA and the NAIC seem to agree that suitability requirements should be "ageless".

FINRA Suitability and Disclosure Rules

FINRA, the Financial Industry Regulatory Authority, is the largest non-governmental regulator of securities firms doing business in the United States. Created in 2007 through the consolidation of NASD's and NYSE's Member Regulation and Arbitration functions, FINRA protects investors and securities market integrity. It does so by registering and educating all industry participants; auditing securities firms; writing and enforcing industry rules and federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities; and resolving disputes between investors and registered firms.

General Standards of Suitability: Rule 2310

FINRA imposes a general requirement on its member firms and their registered representatives that recommendations be "suitable" for each client. The general duty of registered representatives can be found in ***Rule 2310 "Recommendations to Customers (Suitability):***

> (a) 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 such customer as to his other security holdings and as to his financial situation and needs.
> (b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:
>> (1) the customer's financial status;
>> (2) the customer's tax status;
>> (3) the customer's investment objectives; and
>> (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.
>
> (c) For purposes of this Rule, the term "non-institutional customer" shall mean a customer that does not qualify as an "institutional account" under Rule 3110(c)(4).

Variable Annuity Suitability: Rule 2821

FINRA developed Rule 2821 to enhance broker-dealers' compliance and supervisory systems and provide more comprehensive and targeted protection to investors who buy or exchange deferred variable annuities. Deferred variable annuities are complex investments containing both securities and insurance features, which can be confusing for both the agents who sell them and customers who buy them. Rule 2821 was designed to guide agents in formulating suitable recommendations for their clients — and help member firms supervise their representative's annuity business. Rule 2821 has four main points:

Registered Representative's Recommendations

When recommending a deferred annuity transaction, a registered representative must:

- make a reasonable effort to obtain and consider various types of customer-specific information, including age, income, financial situation and needs, investment experience and objectives, intended use of the deferred variable annuity, investment time horizon, existing assets, liquidity needs, liquid net worth, risk tolerance and tax status.
- have a reasonable basis to believe the customer has been informed of the material features of a deferred variable annuity, such as a surrender charge, potential tax penalty, various fees and costs, and market risk. (Delivery of disclosure documents is not, by itself, an adequate effort to "inform" or educate the customer of the important features.)
- have a reasonable basis to believe that the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization or death or living benefits. (The customer need not benefit from all of the features, just that the contract's features could be of benefit to the client.)
- make a customer suitability determination as to the investment in the deferred variable annuity, the investments in the underlying sub-accounts at the time of purchase or exchange, and all riders and other product enhancements and features contained in the annuity contract.
- have a reasonable basis to believe that a deferred annuity exchange transaction is suitable for the particular customer, considering, among other factors, whether the customer would incur a surrender charge, be subject to a new surrender period, lose existing benefits, be subject to increased fees or charges, and has had another exchange within the preceding 36 months.

Principal Review and Approval Obligations for All Transactions

The new rule requires a registered principal (a supervisor such as a branch office manager) to review and determine whether to approve the customer's application for a deferred variable annuity before transmitting the application to the issuing insurance company. The rule calls for principal approval within seven business days after the customer signs the application. A principal must treat all transactions as if they have been recommended for purposes of review and can approve the transaction only if it is suitable based on the factors that a registered representative must consider when making a recommendation. However, the principal *may* authorize the processing of the transaction even if he or she does not approve it based on suitability if, but only if, the following two determinations are made: (1) the transaction was not recommended and (2) the customer, after being told why the principal found it to be unsuitable, still wants to proceed with the purchase or exchange.

Please note: Rule 2821 went into effect in May 2008. Broker-dealers were concerned that the 7-day review period would be insufficient for proper analysis and review of annuity transactions. FINRA is currently not enforcing of the 7-day requirement. FINRA is completing a review of paragraph (c) of the rule and will probably propose changes to the timeframe. The SEC must then approve those changes. In the meantime, the rest of Rule 2821 is effective.

Firm Supervisory Procedures

Broker-dealers must establish and maintain written supervisory procedures reasonably designed to achieve compliance with the rule's standards. One specific requirement is that broker-dealers implement surveillance procedures to determine whether any representatives have a pattern exchanging (replacing) variable annuity contracts that might evidence misconduct. Each firm must have policies and procedures in place to address inappropriate exchanges.

Firm Training Program

The new rule requires firms to create training programs for registered representatives who sell deferred variable annuities and for registered principals who review deferred variable annuity transactions. FINRA offers a webcast of a training program for registered reps and principals at its website.

Variable Annuity Suitability for Registered Representatives	http://www.finra.org/Industry/Education/OnlineLearning/Webcasts/Frontline/p038043
Variable Annuity Suitability for Principals	http://www.finra.org/Industry/Education/OnlineLearning/Webcasts/Frontline/p038044
Variable Annuity Contract Exchanges	http://www.finra.org/Industry/Education/OnlineLearning/Webcasts/Frontline/p013833
Equity Indexed Annuities (and other unregistered securities)	http://www.finra.org/Industry/Education/OnlineLearning/Webcasts/Frontline/p018204
	http://www.finra.org/Industry/Education/OnlineLearning/Webcasts/Frontline/p015626
General Suitability Requirements	http://www.finra.org/Industry/Education/OnlineLearning/Webcasts/Frontline/p015625

Comparison of Florida's and FINRA's Suitability Requirements

While the intent and scope of FINRA's Rules is similar to Florida law, it is important to note some significant differences:

No Age Restrictions. One of the key differences between Florida's suitability requirements and FINRA Rule 2821 is that Florida law applies only to "senior consumers" (i.e., those age 65 or older). Rule 2821 applies to all purchasers of variable annuities regardless of their age.

Reasonable Basis. FINRA Rule 2821 relies on a subjective standard — what the registered representative "reasonably believes" to be suitable. As we discussed earlier, Florida regulators found that standard to be vague and difficult to enforce. Florida's updated suitability regulations are now based on a review of objective criteria.

Deferred Variable Contracts. As we've noted throughout this course, variable annuities are subject to dual regulation — as insurance and securities. That is not the case for fixed annuities (including indexed annuities), which are solely insurance products. As a securities regulator, FINRA's rules extend only to variable annuity transactions. It is useful to note that this rule specifically applies to deferred variable contracts, not variable contracts purchased for immediate annuitization. The rule is concerned with variable annuities as an investment (accumulation) vehicle, not as a means to distribute periodic income.

Purchase and Exchange. The detailed determination of suitability required under Rule 2821 applies only to the "purchase or exchange" of deferred variable contracts. That language seems relatively straightforward — but in application it is not so clear-cut. This rule does not apply to recommendations to sell or liquidate a variable annuity, although the general suitability rule (Rule 2310) does. According to a FINRA regulatory memorandum, the general suitability rule "applies to any recommendation to sell a variable annuity regardless of the use of the proceeds, including situations where the member recommends using the proceeds to purchase an unregistered product such as an equity-indexed annuity. Any recommendation to sell the variable annuity must be based upon the financial situation, objectives and needs of the particular investor" — but the written determination and principal review required under Rule 2821 does not apply. FINRA takes the position that an exchange of a variable annuity for a fixed contract is to be treated as a simple liquidation. Likewise, the exchange of a fixed contract for a variable one is treated as a simple purchase. While such switches constitute "replacement" under state law, they are not treated as an "exchange" for purposes of Rule 2821.

Exchanges within 3 years. A registered representative must determine whether the customer has effected another exchange at the broker-dealer at which he or she is performing the review and must make reasonable efforts to ascertain whether the customer has effected an exchange at any other broker-dealer(s) within the preceding 36 months. State law requires agents to make additional inquiries when an exchange is being recommended by the agent, but it does not require agents to delve into past transactions.

Principal Review. A registered representative who recommends the purchase or exchange of a deferred variable annuity must document and sign the determinations of suitability. This signed document must provide reviewing principals with enough information to adequately assess whether the registered representative has complied with the requirements of Rule 2821. Principals have seven business days to review the application and the rep's determination of suitability. As a result, this can cause a delay in client fund's being invested in the selected subaccounts. The review process may also complicate a broker-dealer's compliance with other requirements: such as custody of funds and prompt execution of orders. [Principals should be aware of the narrow exceptions carved out of these rules to allow for the 7-day review period.] Florida's suitability law does not impose this additional level of review, nor does it require approval by the agent's supervisor prior to each individual transaction. Issuers (or third parties) will review agent compliance after-the-fact, but prior review is not required under state law. [As noted above, the 7-day period is not currently being enforced while FINRA considers adjusting that timeframe.]

Paperwork. Rule 2821 requires a written determination of suitability by the registered representative. That form is submitted, with the application, to a principal of the firm. If the principal declines approval because he or she deems the recommendation unsuitable, the principal can still permit the purchase or exchange under limited circumstances: if the transaction was not recommended by a registered rep, or if the principal explains the reasons the transaction is unsuitable and the client chooses to proceed with the transaction anyway. In either case, the principal must document his or her actions in writing. It is the broker-dealer's (i.e. firm's) responsibility to maintain records of the rep's recommendation and the principal's decision. If the principal approves the transaction, the application must be forwarded to the annuity company within 7 business days. State law, by comparison, requires the agent and the issuing company (or third parties) to retain documents related to the agent’s recommendation. Agents must submit a completed copy of customer questionnaires to the issuing company within 10 days of the application — and, in addition, provide a copy to the client with (or before) delivery of the contract documents. Rule 2821 does not contain any requirement for client disclosure of the suitability determination.

Initial Asset Allocation. State law governing the recommendations on fixed annuity transactions does not deal with the underlying investments within the contract. That is because the assets backing fixed contracts are held in the company's general account, and the contractholder has no control over those investments. The purpose of a variable annuity is to provide the contractholder with control over the investments that support the contract — and the separate investment subaccounts are an integral part of the variable annuity product. Rule 2821 requires registered representatives to determine whether the initial asset allocation among the contract's subaccounts is suitable for the client. The initial asset allocation will be subject to review, and approval, by the firm's principal. This is not true of subsequent reallocations within the contract. Registered representatives should take care that any future reallocations are suitable (under the general suitability rule), but those reallocations need not follow the procedures in Rule 2821.

Exemption for qualified plans. In general, state and FINRA rules on the sales of annuities to retirement plans are similar. Sales to employer-provided plans are exempt from the written suitability requirements; Individual Retirement Accounts are not. (The exemption under Rule 2821 applies to contracts sold to the employer for benefit of the employees as a group. If an annuity is recommended to individual plan participants, the written suitability determination is required)

The full text of Rule 2821 is available at
http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3690