Chapter 1

An Introduction to Variable Insurance Products

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§ 1:1 Background—Variable Annuities and Variable Life Insurance

The growth of variable insurance products in the 1990s and the 2000s was dramatic, and that growth certainly earned those products a place among mutual funds, bank CDs, and traditional insurance products in the mainstream of financial products.

The popularity of variable insurance products reflects broader trends that have occurred in the financial services arena over the past two decades. At the same time, individuals have transformed their investing habits and become increasingly sophisticated as consumers of financial products, financial institutions have broken out of the pigeon holes they once inhabited—banks as places to make deposits, insurance companies as places to shift mortality risk, and mutual funds as places to pool investments. And, while low interest rates and equity market volatility of the past several years have impacted the investment performance of variable insurance products and presented product design challenges for insurers, these contracts continue to be in demand and remain an important source of revenue for the insurance industry.

Variable products are a clear example of how insurance companies have expanded their product base to meet the needs of the increasingly financially savvy investor by directly linking insurance and investments. While traditional insurance products offer consumers a fixed investment return, variable products offer an investment return based on an assortment of investment choices. Where the insurer retains both mortality risk and investment risk in a traditional product, variable products split mortality and investment risk between the insurer and the contract owner. In a variable product, the insurance company retains the mortality risk, while the investment risk is shifted to the contract owner.

There are two types of variable insurance products—variable annuities and variable life. Although both provide a type of insurance, there are significant differences between the two. While life insurance "pays off" when one dies, an annuity offers an opportunity to accumulate assets and to "pay off" for as long as an individual lives. We provide an overview of each of these products below.

§ 1:2 Variable Annuities in Today's Marketplace

§ 1:2.1 Generally

There are two basic types of annuity contracts—deferred and immediate. The insurance provided, which can also be called a guarantee, is the contractual right of the owner to receive an income stream for a set period or for life. The income stream begins when the contract is "annuitized." Upon annuitization, also known as the

"payout phase," the contract's account value is used to help calculate the income payment level. In a deferred annuity, annuitization begins at a future date after the so-called "accumulation phase." This is the period in which money accumulates based on a fixed return, investment performance, or a combination of both. In an immediate annuity, annuitization generally begins immediately (that is, there is little or no accumulation phase).

Most variable annuities fall into the deferred annuity category. In contrast to a fixed deferred annuity, which accumulates money based on a guaranteed rate of interest, variable deferred annuities accumulate money based on the performance of the investment options to which owner payments are allocated. Some variable deferred annuities also permit contract owners to allocate payments to investment options that guarantee a fixed rate of return. This is often called a "guaranteed investment option."

Deferred annuities can be funded with a single one-time payment at the start of the accumulation phase (indeed, there are contracts that only permit a single payment) or there can be an initial payment followed by payments, made on an ad hoc or systematic basis, throughout the accumulation phase. Earnings grow tax-deferred, although income tax on any earnings are payable when amounts are withdrawn.

A contract owner who accumulates money in a deferred annuity contract is not required subsequently to annuitize the contract and begin taking money pursuant to an income stream. Instead, a contract owner can receive his or her money in a lump sum. Whether the contract owner elects to annuitize or to take a lump sum, the contract must terminate by its annuity maturity date. The annuity maturity date is the latest date the annuity can remain in the accumulation phase. Although some states mandate a latest annuity maturity date, maturity dates are primarily driven by the insurer and dictated by the terms of the annuity contract.

Variable annuities are offered in both the retail marketplace and in the retirement marketplace. We discuss each of these below.

§ 1:2.2 *Variable Annuities in the Retail Marketplace*

[A] Generally

Historically, variable annuities were sold in the retail marketplace primarily as accumulation vehicles. Over the last several years, insurers have offered variable annuity contracts with guaranteed "living benefits" and death benefits, both of which have proven very popular among investors. Many believe that increased investor interest in both the payout and withdrawal features of annuities is a direct result of traditional pensions playing less of a role in retirement planning.

As an accumulation vehicle, the variable annuity draws comparisons to the mutual fund. This comparison has often prompted the popular press to refer to variable annuities as "essentially mutual funds in a tax-deferred insurance wrapper." This is because earnings in a mutual fund are generally taxable in the year in which they are earned, whether or not such earnings are withdrawn, while earnings in a variable annuity are not taxable until withdrawn.

In making this comparison, some critics have contended that consumers should choose mutual funds over variable annuities because they are cheaper. The variable annuity industry and its proponents, however, have countered that variable annuities, unlike mutual funds, are more than just an accumulation vehicle. Unlike investments in other accumulation vehicles, such as mutual funds, variable annuity contracts provide significant insurance benefits that are in addition to and overlay the underlying fund investments. Such insurance benefits include contract guarantees—most notably, guaranteed annuity benefits, death benefits, and income benefits. These insurance benefits are a principal reason why investors purchase variable annuities rather than invest those amounts directly in mutual funds and can serve as a fundamental building block of retirement planning.

In order to better understand the current generation of annuity products, some of their unique product features are discussed below.

[B] Insurance and Other Guarantee Features

We begin with annuitization, the most distinctive aspect of an annuity contract. Annuitization is the process by which an annuity contract is converted into an income stream that is guaranteed to last for a designated period of years or for the rest of the contract owner's life (or his or her spouse's life, if elected). When a contract owner elects to annuitize his contract, the accumulation contract and all its benefits are generally terminated; its account value is applied to "purchase" a guaranteed income stream. Once again, this is called the "payout phase." The income stream is offered through a new "supplemental" contract or through the original accumulation contract, then converted into the payout phase. The amount of the annuity payments will depend on a host of factors, including age, gender, and the account value that is applied (which is contingent on the investment performance of the investment options the contract owner allocated payments to during the accumulation phase). If the contract owner chooses a fixed income stream, income payments will not vary according to market conditions. If the contract owner chooses a variable income stream, payments will vary based on the investment options selected.

In addition to the benefit of annuitization, many deferred variable annuities offer death benefit features and living benefit features.

Death benefits offer investors the opportunity to provide a beneficary(ies) with a guaranteed minimum amount of assets at death, while living benefits help investors lock in guaranteed levels of future income. Both types of benefits guarantee minimum amounts, regardless of investment performance. These benefits may be offered as part of the base annuity contract at no additional charge, but they are most often available as optional benefits for an additional charge.

Death benefits. Beginning in the mid-1990s, insurers began designing and marketing a number of optional guaranteed minimum death benefits, which continue to be quite popular in the marketplace today. Prior to the introduction of guaranteed minimum death benefits, the amount payable upon death was typically the contract's account value. Guaranteed minimum death benefits generally guarantee that the amount paid upon death will equal the greater of the account value or a guaranteed minimum amount. The minimum amount varies based on the type of guaranteed death benefit offered. Such guaranteed minimum amounts generally include:

- the sum of total contributions made; or
- the highest account value on any contract date anniversary (HAV); or
- the greater of the HAV and total contributions made increased by a guaranteed annual crediting rate.

In certain circumstances, investors are able to take a certain level of withdrawals without decreasing their guaranteed minimum death benefit. Some insurers also offer an "earnings-enhancement" death benefit. This feature effectively "tops off" the guaranteed minimum death benefit by an amount—typically 25% to 40%—of the earnings in the contract. Insurers that offer this feature often market it as a tool to help offset taxes that may be due when the death benefit is paid.

Charges for these death benefits vary in amount and structure. They are deducted from the contract's account value on a set periodic basis, typically annually or quarterly, and are generally equal to a dollar amount that reflects a percentage of account value or a defined benefit base. The charge could also be based on the insurer's net amount at risk, that is, the gap between account value and the death benefit payable as of the day the charge is deducted.

Living benefits. Living benefits have been available in the market for more than fifteen years. Today, living benefits generally allow contract owners to invest in the market and, regardless of investment performance, lock in a guaranteed minimum income stream for life. These

benefits can be categorized as follows: (i) those that provide a guaranteed income stream during the accumulation phase, and (ii) those that instead provide income in the payout phase. In addition, some variable annuities continue to offer benefits that guarantee investors a minimum account balance for a specified period of time.

The Guaranteed Minimum Income Benefit (GMIB) was the first living benefit to gain popularity in the marketplace. A contract owner's contributions are allocated pursuant to his allocation instructions, and his account value will fluctuate according to market performance. However, regardless of investment performance, these contribution amounts "roll up" at a guaranteed annual crediting rate. Historically, these crediting rates have generally ranged from 4% to 7%. Also, some GMIB designs now include an annual crediting rate that "floats" in connection with a specified published market rate. Total contributions plus annual amounts credited to those contributions equal the GMIB "benefit base." When the contract owner is ready to begin receiving his guaranteed income stream, he must annuitize his contract. The GMIB benefit base, if higher than the account value, is applied to calculate the guaranteed minimum income stream. There is typically a waiting period before a contract owner can exercise the GMIB, and specific annuity payout options are often required upon such exercise.

With some GMIB designs, the GMIB benefit base can be further increased based on a periodic reset, which increases the benefit base to equal the account value, if higher, on specified contract date anniversaries. The reset not only increases the GMIB benefit base to equal the greater account value amount, but the annual crediting rate is then applied to the larger benefit base, resulting in larger roll up amounts. Last, it is important to note that many GMIBs are designed to enable contract owners to take a certain amount of withdrawals during the accumulation phase without decreasing their GMIB benefit base. This withdrawal feature was an attractive selling point for investors, and it served as a key design point for the next generation of living benefits.

Currently, a living benefit widely known as the Guaranteed Withdrawal Benefit for Life (GWBL) is the most popular living benefit in the market. Unlike the GMIB, the GWBL provides guaranteed annual lifetime payments without having to annuitize the variable annuity contract. Contract owners are able to withdraw a percentage of their total contributions for life. For example, if you contribute $100,000, and the withdrawal percentage in effect at the time of the contribution is 5%, you can withdraw $5,000 per year for life. If the percentage in effect varies from contribution to contribution, your guaranteed annual withdrawal amount will be calculated based on a blending of

those percentages. With some designs, the guaranteed annual withdrawal amount may be increased by positive investment performance or if a contract owner defers withdrawals to an older age.

The predecessor to the GWBL is the Guaranteed Withdrawal Benefit (GWB). This benefit functions much like the GWBL in that it guarantees an income stream and does not require annuitization; however, the income stream is guaranteed for a set period of time and typically reflects a return of contributions only. In other words, it is not a "for life" income stream.

Unlike living benefits that offer an income stream through distributions or withdrawals, the Guaranteed Minimum Accumulation Benefit (GMAB) feature guarantees contract owners a minimum account balance as of a future specific date, regardless of investment performance. GMAB is often available as a partial investment strategy: a contract owner can allocate a portion of his contribution to GMAB, thereby "protecting" that part of his investment, while subjecting the balance of his contribution to market risk.

Death benefit and living benefit investment restrictions. It is important to note that when living benefits were initially introduced, contract owners were typically able to freely invest their contributions among all the investment options offered under the contract. This is sometimes referred to as "open architecture." Today, however, most living benefits, as well as certain death benefits, restrict contract owners to certain investment options or limit allocations among investment options to certain percentages. This is sometimes referred to as "closed architecture" or "guided open architecture," respectively. In addition, some insurance companies reserve the right to move money back and forth between the contract owner's selected investment options and a dedicated fixed account or fund at certain points in time based on the ratio between account value and benefit base. These design changes enable insurance companies to more efficiently manage the risks associated with offering living benefits.

Like charges for death benefits, living benefit charges vary in amount and structure, and they are deducted from the contract's account value on a set periodic basis.

Table 1-1
Variable Annuity Riders

Type	Nature of Guarantee
GMDB—Guaranteed Minimum Death Benefit	Guaranteed minimum lump-sum payment on death
GMIB—Guaranteed Minimum Income Benefit	Guaranteed minimum income stream at annuitization
GWBL—Guaranteed Minimum Withdrawal Benefit	Guaranteed annual withdrawals for life
GWB—Guaranteed Withdrawal Benefit	Return of contributions through withdrawals over specified period of time
GMAB—Guaranteed Minimum Accumulation Benefit	Lump-sum payment at end of specified period

[C] Current Product-Related Developments

Following the financial crisis in 2008, insurance companies have generally sought more fully to diversify their product offerings, and shift the balance away from guaranteed benefits—which can be very expensive to support. Accordingly, some companies have introduced new insurance products that do not (yet) offer living benefits, but provide a certain level of protection from market losses. One such product offers contract owners the ability to participate in the performance of an index that tracks an equity or commodity market, or in the performance of a fund, for a certain period of time, subject to a cap on such performance and a promise by the insurance company to absorb some negative performance—either by "flooring" any contract owner loss to a specified amount, for example, -10%, or by agreeing to absorb a specified amount of any loss, for example, the insurer will absorb the first 10% of contract owner loss. These are sometimes called "floored annuities" and "buffered annuities," respectively.

Another trend in the marketplace includes variable annuities that offer neither guaranteed benefits nor downside protection. These products, often referred to as "investment only variable annuities" or "IOVAs," emphasize investments, by providing a wide array of investment options typically in excess of 100 options, including some alternative-type investments. Some of these contracts also offer more tax efficient distributions than traditional variable annuity

distribution. Such distributions are made via scheduled payments over a set period of time, and a portion of each payment is a return of cost basis and thus excludable from taxes.

While many insurers have long engaged in hedging programs in order to manage risks (especially risks related to guaranteed benefits), the sharp decline in the financial markets in 2008, as well as the aforementioned periods of significant market volatility and a prolonged low interest rate environment, has required insurance companies to focus even more keenly on effective risk management. Indeed, today's variable annuity issuers are engaged, on an ongoing basis, in a wide array of "de-risking" initiatives. Not only have insurance companies made adjustments to their new product offerings' design, including available investment choices and investment restrictions, some insurance companies have also made changes to customers' existing contracts, as permitted. These changes have included increasing charges, discontinuing the acceptance of contributions, and making underlying fund changes—primarily through substitutions.

Certain insurance companies have exited the variable annuity marketplace entirely, while others have pulled out of the market for a limited time period or stopped selling guaranteed benefits. A rather novel risk management strategy has emerged—known as "buy back" offers—in which an insurance company offers an existing contract owner the opportunity to terminate his/her guaranteed benefit and/or surrender or exchange his/her contract in return for an increase in account value or lump sum of money. More recently, some insurers have offered clients both the ability waive any remaining waiting period to exercise their GMIB and an enhanced payment stream upon such exercise. Also, the market has seen insurers offer a lump sum buyout at the point of exercise, in lieu of a lifetime payment stream. Given the historic great popularity of guaranteed benefits and the multitude of legacy guaranteed benefit contracts, it is likely that insurance companies will continue to stay focused on de-risking measures.

[C][1] Recent Regulatory-Driven Product Developments

Last, in response to the adoption of the Department of Labor (DOL) Fiduciary Rule and related exemptions (together, the "Fiduciary Rule"),[1] there has been a flurry of product development across insurance companies. Here, the focus is how to offer variable annuity contracts in the retirement plan and IRA markets while facilitating distribution partners' compliance with the Fiduciary Rule's so-called

1. *See* Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,946 (Apr. 8, 2016).

Best Interest Contract (BICE)[2] requirements. Compliance with the applicable BICE provisions has necessitated a review and reevaluation by third parties offering contracts of the source, form, and amount of compensation they receive in connection with the contract recommendations they make. It has also prompted a reevaluation of the fees, costs, and benefits associated with variable annuity contracts themselves. These considerations have already started to manifest a shift in the variable product marketplace in the form of decreased base contract charges. Most notably, insurers appear to be lowering the mortality and expense risk charges and/or shortening or eliminating surrender charge fees. The marketplace is also seeing the elimination or reduction of insurer paid financial professional compensation. With regard to this last point, numerous insurers are entering or re-entering the "adviser" sales channel, where the contract is generally sold by broker-dealers who are registered as, or affiliated with, an investment adviser who recommends the contract. The insurer does not make any independent investigation of the investment adviser or endorse the adviser's qualifications. Commission payments are not made by the insurer; an advisory fee payment is set by the investment adviser firm. Some insurers do, however, permit the contract owner to take withdrawals to pay the advisory fee and have built in contract mechanics to do so. While it will take several years to fully appreciate the DOL Fiduciary Rule's ultimate impact on the variable product marketplace, it is clear that insurance companies are proactively changing their contracts and more changes are likely to come.

[D] Variable Annuity Share Classes

Similar to mutual fund "A" and "B" shares, variable annuities are typically offered with a variety of pricing structures or share classes. The most common share classes are described below. A variable annuity contract's share class is directly related to how the financial professional who sells the contract gets paid.

"A" share contracts typically charge the contract owner a "front-end" sales load, as opposed to a "back-end" load (also known as a contingent

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2. This part of the Fiduciary Rule is the Best Interest Contract Exemption, or "BICE." *See* 81 Fed. Reg. 21,002–89 (Apr. 8, 2016). It states that investment advisers and the financial institutions that engage them must: (1) acknowledge their fiduciary status to investors; (2) adhere to impartial conduct standards, including giving advice in the investor's best interests, charging only reasonable compensation, and making no false or misleading statements; (3) implement policies and procedures to ensure impartial conduct; (4) refrain from using incentives for advisors to act contrary to investors' best interests; and (5) disclose fees, compensation, and material conflicts of interest associated with advisor recommendations. *See* 81 Fed. Reg. at 21,007.

withdrawal charge or surrender charge), and relatively low ongoing asset-based charges.[3] When a front-end load is assessed, an amount equal to a set percentage of each contribution is deducted from the contribution, and the net contribution is then invested. Compensation to the financial professional and/or selling broker-dealer is typically structured as an up-front payment (based on a percentage of each contribution) at the time of the contribution. A trail commission may be paid over a period of time while the contract owner remains invested in the product. Trail commissions are annual payments based on a percentage of the account value.

"B" share contracts charge the contract owner a back-end sales load that typically lasts between six to eight years, and offer relatively higher ongoing asset-based charges. A back-end sales load may be imposed for a period that is based on the contract issue date (for example, the surrender charge applies for the first eight contract years) or on a rolling basis (for example, each contribution is subject to an eight-year surrender charge period irrespective of the contract issue date). These charge structures often reflect a declining surrender charge percentage as the contract or contribution ages. The former is often called "contract-based surrender charges," while the latter is called "rolling" surrender charges. Like "A" shares, compensation to the financial professional is typically structured as an up-front payment at the time of the contribution with a trail commission paid over a set period of time. A variation of a "B" share contract is the bonus contract, where contract owners are paid a credit, calculated as a percentage of each contribution, which is added to the account value. Bonus products typically have a higher sales load percentage, a longer back-end sales load period, and higher ongoing asset-based charges. Also, the "credit" is typically subject to the recapture by the insurance company based on certain triggering events. "B" share contracts tend to make sense for contract owners who do not intend to make withdrawals until the end of the entire surrender period.

"C" share contracts do not charge contract owners a back-end or front-end sales loads. Accordingly, they offer full liquidity to contract owners at any time. "C" shares typically provide for a small up-front payment to the financial professional and a levelized trail commission stream (for example, the financial professional is paid 1% of the assets annually). "C" shares typically assess the highest ongoing asset-based charges of all variable annuity contracts. "C" share contracts tend to make sense for contract owners who want unencumbered access to

3. An "asset-based" charge, as discussed in more detail below, is a charge that is equal to a percentage of the contract's account value (which fluctuates based on investment performance).

their investment immediately after investing and are willing to pay higher fees in exchange for that flexibility.

"L" share contracts charge contract owners a back-end sales load, typically ranging from about three to five years. "L" shares generally assess higher ongoing asset-based charges than "B" share classes. Typically, an up-front payment is paid to the financial professional at the time of the transaction, and a trail commission is also paid over the life of the contract, starting after the surrender charge period ends. Over the years, regulators have expressed concerns about the sale of "L" shares and the possibility that contract owners, who may not truly have the liquidity need that should drive the purchase of an "L" share contract, are being steered toward this higher charge product because the payments to the selling firms/financial professionals tend to be higher. Indeed, settlements of FINRA enforcement actions related to "L" share contracts were announced in November 2016, and a number of variable annuity providers have stopped selling "L" shares in response to both a decreased demand and said regulatory scrutiny.

[E] Unique Investment Features

Variable annuities offer some unique investment features. Unlike mutual funds, they offer investors the ability to transfer their money from one fund to another on a tax-deferred basis. Also, variable annuities are sometimes issued in connection with fixed-rate investment options and/or market value adjustment (MVA) options. A fixed rate option provides contract owners with the ability to allocate monies to the insurer's general account at a guaranteed fixed rate of interest. MVAs provide the contract owner with the ability to invest monies for a set period of time at a guaranteed interest rate, subject to a potential increase or decrease in the amount allocated to the option should the contract owner withdraw the money before the end of the time period. The adjustment is based on a comparison of the guaranteed interest rate to the current market interest rate. MVAs and fixed-rate annuities, as briefly discussed above, can also be sold as stand-alone products. Interests in an MVA are generally registered as securities, as the adjustment can result in investment loss.

Other popular features include: (1) dollar cost averaging, which allows contract owners to gradually invest money in an investment option through automatic periodic transfers, which may enable them to get a lower average cost over time; (2) rebalancing, which enables contract owners to have their account value periodically rebalanced, on an automated basis, to the allocation percentages indicated in their investment allocation instructions; and (3) asset allocation programs, which programmatically guide contract owners, based on their stated investment objectives and risk tolerance, to a set of investment options.

§ 1:2.3 Annuities Sold in the Retirement Marketplace

Many annuities are designed as a vehicle for employer retirement plans. These employers include corporations, governmental units, tax-exempt organizations and other entities that sponsor the following types of plans:

- 403(b) (employees of educational institutions and other public entities);
- 457 (employees of states, counties, and municipalities); and
- 401(k) (corporations and other private entities).

An employee can opt to contribute part of his salary into the plan, and the money is automatically deducted from his paycheck before taxes are taken out. Annuities offered in the retirement marketplace are typically designed as group contracts. Here, the insurer and the plan enter into a master contract, and the rights of participating employees are evidenced by certificates. While variable annuities that fund 403(b) plans and certain 457 plans are registered as securities, variable annuities that fund 401(k) plans and 457 governmental plans are typically not registered, and hence not sold through a prospectus. The applicability of registration requirements are discussed in detail later in this chapter.

§ 1:3 Variable Life Insurance in Today's Marketplace

§ 1:3.1 Generally

Life insurance comes in various "shapes and sizes." These variations have one thing in common: they offer the contract owner a death benefit (that is, an amount the life insurer is obligated to pay upon the death of the insured). The simplest type of life insurance is term insurance. Term insurance offers a death benefit in exchange for specified premium payments. The insurance covers a person for a certain period of time (one or more years) and the death benefit will be paid only if the person dies within the term covered. Term life insurance has no cash value—that means that when the term ends, the contract ends without value.

Other forms of life insurance have another feature besides a death benefit—they offer an ability to accumulate cash value. This type of insurance is referred to as permanent insurance. Such insurance covers the insured as long as the required premium payments are made. The accumulated cash value generally grows on a tax-deferred basis and may be accessed by the contract owner through loans or withdrawals.

There are three basic types of permanent life insurance: traditional (also called classic or fixed), universal, and variable.

In a traditional life insurance policy, cash value accumulates at a guaranteed rate, and the insurance company pays a death benefit upon the insured's death. Contract owners are required to pay premiums according to a set schedule.

In a universal life insurance policy, the cash value is not credited with a fixed amount. Rather, it is credited with a contractually guaranteed minimum interest rate, such as 3.5%. Policy value may earn a higher rate of return based on the current interest rate declared by the company. The contract owner determines the amount and frequency of the premium payments, provided there is sufficient policy value at all times to pay charges and keep the policy in force. There are generally two forms of death benefits. One form pays a level death benefit. The other form provides for a death benefit that increases corresponding to increases in cash value.

In a variable life policy, the policy value fluctuates depending on the investment performance of the funds in which contributions are invested. Some variable life policies (scheduled premium variable life insurance) require that premiums be paid according to a set schedule. The more popular form (referred to as "flexible premium variable life insurance" or "variable universal life insurance") provides flexibility with respect to the amount and timing of premiums. Of course, there must always be sufficient account policy to cover policy charges, in order for the policy to remain in force. Similar to universal life, there are generally two forms of death benefit: fixed or one that varies according to investment experience.

§ 1:3.2 Variable Life Insurance in the Retail Marketplace

As a retail product, variable life is designed first and foremost to provide a death benefit. While variable life also offers the ability to accumulate cash, because significant insurance charges are imposed, variable life does not typically offer accumulation at the same pace as "purer" cash accumulation vehicles, like mutual funds and variable annuities.

Variable life insurance policies are often available with a number of additional riders, available at an extra cost, which are designed to enhance the flexibility and utility of a policy. Such riders may include: (i) Waiver of premium rider (which provides a waiver of premiums should the policy owner become "disabled"); (ii) Disability income rider (provides income payments during period of disability); (iii) Guaranteed insurability rider (which guarantees a policy owner's ability to add more insurance coverage at a later date, absent any additional underwriting); (iv) Critical Illness rider (provides a lump-sum payment in the event of a specific illness); (v) Accelerated death

benefit rider (which provides for a payment of part or all of the death benefit in the event of terminal illness); (vi) No lapse guarantee rider (which generally guarantees that a policy will not lapse, for a specified period, regardless of investment performance, provided certain premium amounts are paid); (vii) Accidental death benefit rider (which increases the death benefit if the death occurs via an accident); and, perhaps, most common; (viii) Term rider (which provides an additional amount of coverage for a stated period of time). The availability of life insurance riders varies from company to company, of course, and is typically subject to numerous limitations and restrictions, as well as ages at which the rider automatically expires.

A notable marketplace trend in recent years is life insurance companies offering discounts for employees who participate in wellness programs and for individuals who commit to tracking their activity through technology such as Fitbit. In other words, policy owners who are willing to share some personal data with their insurers can get a pricing advantage. This is inevitably only the start of insurance companies implementing different technologies to provide more flexible pricing, and a shift from one-size-fits-all solutions to more tailored policy owner arrangements.

§ 1:3.3 Life Insurance Sold to Individuals Through Employers and Associations

Some companies offer group life insurance contracts tailored to the workplace. These contracts are typically offered in connection with programs in which employees (or association members) may elect, on a voluntary contributory basis, to become certificate holders. The certificate provides participants with many of the same features as an individual life contract.

§ 1:3.4 Life Insurance Sold to Businesses (Corporate Owned Life Insurance)

A significant amount of life insurance is sold in the Corporate Owned Life Insurance (commonly called COLI) and business-related insurance marketplace. In the COLI market, life insurance (including variable life) is used for a number of different purposes, including providing fringe benefits to executives, as an alternative or supplement to qualified retirement plan funding, and as funding vehicles in connection with corporate obligations to pay employee deferred compensation benefits. COLI and/or individual variable life insurance can also be used to fund buy-sell agreements, which are contracts between co-business owners that establish a predetermined price for a deceased business owner's share of the business. The business owners then purchase life insurance on each other's lives to cover the purchase

amount. Another popular use of life insurance in the business arena is "key person" insurance, which insures the life of a critical employee whose death could potentially impact a company's profitability or create unexpected costs and resource issues.

§ 1:4 Legal Structure and Changes

An "insulated" separate account of the insurance company—not the insurer's general account—funds an insurer's variable contracts. A separate account may be analogized to a trust established by the insurance company on behalf of the variable product contract owners. Its assets and liabilities are kept separate and apart from the insurer's general account assets and liabilities, and are thereby not subject to the insurer's general creditors.

Separate accounts are typically divided into sub-accounts, also known as variable investment options, each of which invests in a corresponding mutual fund. Contract owners allocate their contributions to the sub-accounts of their choosing and those sub-accounts, in turn, invest in shares of the corresponding fund.

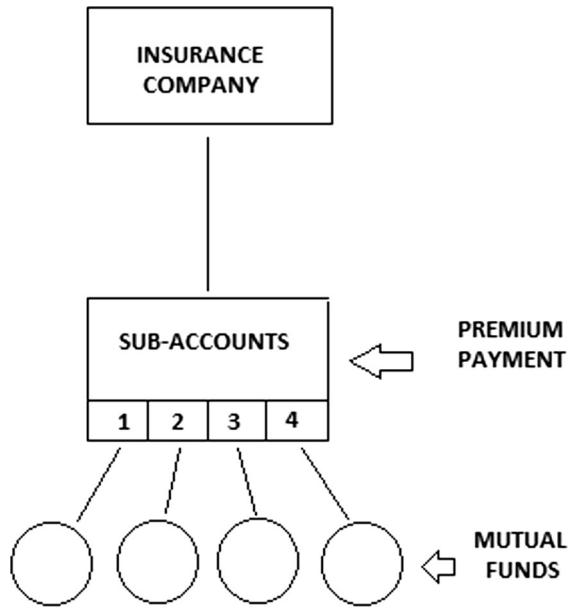
Most variable products offer a variety of underlying mutual funds for an investor to select. Because the Internal Revenue Code wants to assure that the contract is purchased for insurance reasons and not simply to shelter income from taxation, there are various conditions that are imposed by tax law with respect to the mutual funds offered in a variable product.

First, the mutual funds that are available through the contract are pre-selected—an investor is not free to choose any fund in the market that he or she wishes. He must choose from among the menu of funds pre-selected by the insurance company.

Second, the number of funds that may be offered by the insurer is probably not unlimited. While no exact number is imposed, the Internal Revenue Service has, at times, expressed concerns about a variable product being disguised to operate as a "mutual fund supermarket."

Third, generally, the mutual funds that are offered may not be offered in the retail marketplace. These conditions are imposed in order to ensure that the investment features of the product do not overtake the insurance features. If these conditions are not satisfied, the tax-advantages of owning an insurance product would be lost. Notably, these conditions only apply to non-qualified variable contracts. However, because it is typical for insurance companies to offer both qualified and non-qualified registered contracts out of the same separate account, insurers (perhaps for ease of administration) often impose the same conditions on their qualified variable insurance contracts.

Figure 1-1
Contributions and Premium Payments



Generally, there are four types of charges assessed in connection with owning a variable annuity or variable life contract:

(1) *Sales load*. Sales load charges are assessed either as "front-end" charges or "back-end" charges. The front-end charge is taken as a percentage of a contribution, before any monies are applied to the contract. The applicable back-end sales load is generally based on a sliding scale of percentages, from highest to lowest, depending on the number of years that have elapsed since the contract was issued (or, for rolling surrender charges, how many years have elapsed since the date of the contribution). Sales loads are considered "transaction" charges, as the charge is only triggered by contract owner action: making a contribution or taking a withdrawal;

(2) *Administrative charge*. This charge is intended to cover administrative services provided in connection with the contract. It is typically deducted one time per year from the account value;

(3) *Separate account charge*. This charge, while it goes by many names depending on the insurance company, is designed to

compensate the insurer for a variety of expenses, including operational, administration, distribution costs, and mortality and expenses risks. The mortality and expense risk is that an insurer's mortality assumptions differ from actual experience and that its expected expenses are greater, respectively. Separate account charges are assessed daily based on the assets in the separate account, and they are reflected in the daily unit value associated with each variable investment option; and

(4) *Underlying fund charges*. These charges are deducted at the fund level and are reflected in the daily share price of each fund. The charges typically include an investment management fee, a distribution fee, operations and transactional fees, as well as 12b-1 fees.

In addition, variable life contracts assess a fifth charge: *a cost of insurance charge*, which is the cost of the death benefit provided. There are charges assessed in connection with certain optional features elected, as well. Increasingly, insurers are also assessing charges related to "special services," such as wire transfers, express mail, requests for illustrations or duplicate contracts, requests to transfer your contract's value to another carrier, and the like. Some insurers also charge for transfers between investment options. Last, there are charges in connection with elected riders, such as a living benefit, which are typically taken on each contract date anniversary on which the rider is in effect on a quarterly basis.

§ 1:5 Regulatory Treatment of Variable Products

§ 1:5.1 Generally

The relationship between an insurer and a contract owner is established by contract. It is the contract that spells out the legal rights and obligations of the insurer and the contract owner.

This insurer-contract owner relationship is governed in a comprehensive and rather paternalistic manner by state insurance departments. In 1945, Congress enacted the McCarran-Ferguson Act, which established that regulation of insurance was the exclusive prerogative of the states. As a result, today states directly regulate variable annuity and life insurance contracts ("variable insurance contracts"). In this regard, the National Association of Insurance Commissioners, an organization made up of state insurance regulators, has adopted Model Regulations for variable annuities and variable life insurance contracts that have been adopted, in whole or part, by many states.

With respect to relationship variable insurance contracts, in addition to the contract, there is a relationship between security issuer and

investor. This relationship is subject to comprehensive regulation by the Securities and Exchange Commission (SEC), typically under both the Securities Act of 1933 (the "Securities Act") and the Investment Company Act of 1940 (the "Investment Company Act"). One fundamental requirement of this regulatory structure is that an investor receives a prospectus (or disclosure document, depending on the arrangement) with respect to his or her investment.

In addition to state insurance laws and the federal securities laws, the tax code plays an important role in the regulatory structure. Also, if a product is used to fund a qualified retirement plan, the Employee Retirement Income Security Act of 1974 (ERISA) will govern important aspects of the product.

It is important for legal and compliance personnel to parse through these various (sometimes conflicting) regulatory requirements. As explored below, the regulatory framework applied to variable insurance contracts covers almost every aspect of the business, from product design and administration to product distribution and marketing.

§ 1:5.2 Product Design and Approval

A variable product needs to satisfy both state and SEC requirements.

[A] State Insurance Requirements Regarding Product Design and Approval

Various state approvals are needed once the product is designed and before sales commence. First, the insurer needs to have variable product authority in each state in which it will engage in business. Some states treat variable life insurance and variable annuities as requiring separate approvals. Second, if a separate account is created in connection with the product, as is typically the case, additional state approvals will be necessary. The establishment of a separate account at the state level may require the filing of a plan of operations and extensive support documentation. Third, a prototype of the contract needs to be approved in each state in which the insurer will transact business. In reviewing such a contract, staff from the state insurance departments will generally seek to ensure that the contract does not contain any provision that is unjust, unfair, ambiguous, or misleading. Many states require the insurer to obtain approval in the insurer's domicile state prior to making a filing. Some states first require completion of the SEC registration process.

Notably, the Interstate Insurance Product Regulation Commission (the "Compact") is bringing increasing ease to the "state-by-state" approval process. The Compact is a multi-state public entity (with over forty members), which provides a central point of electronic filing for certain insurance products, including certain variable insurance

contracts, and applies uniform product standards. A central filing repository and national review standards have greatly enhanced the efficiency and effectiveness of the way insurance products are filed, reviewed, and approved. Insurers are now able to greatly reduce the number of filings they need to make (and ensuing comments they have to manage) in connection with the launch of certain new products.

To round out the insurance "regulatory" picture, it is also important to note that the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") established a new office within the Department of the Treasury called the Federal Insurance Office (FIO). While FIO does not have a regulatory function, its current mission is to enhance understanding of insurance issues at the federal level and monitor all aspects of the insurance industry. To this end, FIO has been given the authority to gather data and information, with particular emphasis on identifying potential gaps in insurance regulation that could lead to a systemic crisis in the insurance industry or our financial system. It is to make recommendations about such systemic risk, as well as the appropriateness of federal insurance regulation, in general. More immediately, it has been charged with studying how to modernize and improve insurance regulation and reporting to Congress on its findings and recommendations. In addition, FIO has a number of other responsibilities, including representing the United States and assisting the Treasury Department in connection with various international insurance matters and assessing and monitoring the accessibility of insurance products to historically underserved communities and customer bases.

The regulation of insurance has been and continues to be a state domain, and, at present, FIO's function is strictly a monitoring and advisory one. Whether FIO's role remains limited to tasks of this nature, or, instead, expands into a regulatory one will be a topic of great interest as FIO continues to grow.

[B] Federal Securities Laws Regarding Product Design and Approval

[B][1] Background

Based on a 1959 U.S. Supreme Court case, *SEC v. Variable Annuity Life Insurance Company of America*,[4] variable insurance contracts are regulated as securities under the Securities Act. At the heart of the Securities Act is a requirement that a statutory prospectus be used in connection with sales. This means that a registration statement (containing the statutory prospectus among other things) relating to the variable insurance contract needs to be filed with the SEC.

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4. SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65 (1959).

In addition to variable insurance contracts being regulated as securities under the Securities Act, separate accounts offering variable insurance contracts are regulated as investment companies under the Investment Company Act of 1940. This subjects such variable insurance contracts to a very broad and detailed scheme of regulation.

Interests in variable insurance contracts and the separate accounts that issue them are registered jointly using the same form: in general, Form N-4 is used to register variable annuities and Form N-6 is used to register variable life. The initial registration statement is reviewed by the SEC staff and declared effective by the SEC. Post-effective amendments are filed at least one time per year, in order to update the requisite financial statements contained in the registration statement. Post-effective amendments are filed with the SEC staff at other times during the year to reflect certain material and non-material changes to the offering prospectus or to other parts of the registration statement. Other filings sometimes referred to as "stickers," which are not considered post-effective amendments, may also be filed in connection with certain changes.

Until the late 1990s, one of the most controversial elements of the Investment Company Act regulation related to restrictions placed on charges. The SEC had traditionally regulated variable insurance contracts under the onerous Investment Company Act regulations applied to periodic payment plans. (The traditional periodic plan, which offered investors the opportunity to buy mutual funds in installments, was popular in the 1960s, but is almost extinct today.) Sales charges were limited to 9% of total premiums paid under the contract. Administrative charges were limited to the cost of services to be provided under the contracts. Mortality and expense risk charges were limited and could only be deducted pursuant to exemptive relief or an SEC rule.

Legislation in 1996 amended the Investment Company Act to remove variable insurance contracts from the strict provisions applied to periodic payment plans. The legislation removed restrictions that had been imposed on charges and substituted an aggregate reasonableness standard. This standard is generally similar to that applying to mutual funds. Specifically, the aggregate fees and charges under a contract must be reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company. The insurance company must expressly represent that a variable insurance contract's aggregate insurance charges are reasonable in the contract's registration statement and in all amendments to such registration statement.

Notably, the introduction of a reasonableness standard into the regulation of variable insurance contracts greatly contributed to the explosion of new features and benefits in the variable annuity world, as

well as enhanced the charge structure of variable life insurance contracts.

[B][2] Private Offering Exception

Many variable life policies are designed to rely on the private offering exception under the federal securities laws. These products are typically sold in either the high-net-worth individual marketplace or the institutional marketplace (for example, the COLI marketplace discussed above). Private placement life insurance, as opposed to retail variable life, typically offers alternative types of investment vehicles (for example, hedge funds) and more custom-made product design features.

[B][3] Retirement Plan Exemption

As noted above, certain annuity products are designed specifically with an eye to the retirement plan marketplace. Variable products offered in connection with sponsoring plans under Internal Revenue Code sections 401(a), 401(k), 403(a), 404(a)(2), 414(d), or 457(b) are eligible for an exemption from the securities laws.

Section 3(a)(2) of the Securities Act provides this exemption. In such plans, a sponsor/trustee stands between the investment vehicle and plan participants, arguably making the protections of the Securities Act less necessary. Likewise, section 3(c)(11) of the Investment Company Act excludes the separate accounts offering the annuities from regulation under that act.

Even though exempt, the variable contract is still considered a security and is, therefore, subject to the anti-fraud provisions.

In contrast to annuity products that are offered in connection with the above-referenced qualified plans, annuities offered in connection with 403(b) plans are not entitled to an exception from the Securities Act. While some 403(b) plans are ERISA-covered (and thereby involve a plan sponsor), the Securities Act makes no distinction. As a result, variable annuities offered in connection with a 403(b) plan are not entitled to rely on the section 3(a)(2) exception, even if such plan is ERISA-covered. Also, a variable annuity contract offered in connection with a retirement plan that is otherwise exempt but is owned by a self-employed individual or an owner-employee generally cannot avail itself of an exemption under the Securities Act, and hence must be registered.

[C] State Securities Laws

Each of the fifty states, plus the District of Columbia, Puerto Rico, and Guam regulate securities activities through laws typically referred to as Blue Sky Laws. These laws are administered by the state

department responsible for securities. Until the adoption of the Securities Act, states had exclusive jurisdiction over securities offerings. At that point in time, Congress opted *not* to preempt state blue sky laws; instead, it set up a system of concurrent jurisdiction, requiring participants in the securities marketplace to comply with both federal and state laws.

In 1996, Congress adopted the National Securities Markets Improvement Act. Among the changes made by this act was the creation of the concept of a "covered security." For the first time, Congress exempted covered securities from regulation by the states. Securities issued by a company registered under the Investment Company Act are included among the definition of covered securities. Accordingly, in general, variable insurance contracts are excluded from coverage under state securities law and, as a result, state securities departments are not involved in the approval of variable products. A handful of states require variable product issuers to make notice filings and pay filing fees.

It is also worth noting that in August 2002 the National Conference of Commissioners on Uniform State Laws (NCCUSL) adopted an updated version of the Uniform Securities Act. The updated version modifies an amendment proposed by the North American Securities Administrators Associates (NASAA) that would have brought variable insurance contracts within the definition of "security." Instead, the amendment leaves it up to each individual state to decide whether to include variable insurance contracts within the definition of the term "security."

The practical effect of NASAA's efforts would be to require the state securities registration of persons selling variable products, not the registration or approval of the product under state securities laws. It appears that product issues would continue to be left with the SEC and state insurance departments.

§ 1:5.3 Product Administration

Once a variable insurance contract is sold, it must be maintained and serviced by the insurance company. The administration of variable insurance contracts includes a wide range of requests and actions, including a contract owner seeking to take a loan on a life policy, increasing or decreasing the death benefit, transferring money from one investment option to another, changing a death benefit beneficiary, or adding money, etc.

As part of their comprehensive regulation of the insurer-contract owner relationship, states play an active role in reviewing contract administration.

In addition, the federal securities laws, particularly the Investment Company Act, have a very strict regulatory regime for certain aspects of variable insurance contract administration.

For example, purchases and redemptions are subject to the processing requirements imposed by Rule 22c-1 under the Investment Company Act, which mandate that an investment company (including a registered separate account offering variable insurance contracts) issue or repurchase its shares based on the price next determined after receipt of the investor's request. The Investment Company Act rules offer flexibility with respect to the initial purchase of variable life and variable annuity contracts, which provide additional time for insurance companies to gather the requisite information needed to issue a variable insurance contract prior to investing the contribution.

The Investment Company Act also requires insurance companies to pay out proceeds in connection with a redemption request within seven calendar days. Some insurance companies find this requirement challenging, as often such requests are in connection with the surrender of a contract. In the event of a request to surrender, insurers are always challenged by this seven-day requirement, as they would like sufficient time to contact contract owners, in an effort to better understand the surrender request and encourage the contract owner to keep the contract in force, if appropriate.

Also, exchanges and offers to exchange one variable insurance contract for another are also regulated under section 11 of the Investment Company Act. Section 11 generally prohibits an insurance company and affiliates from making an offer to a variable insurance contract owner to exchange an existing contract for another variable insurance contract issued by the insurer or its affiliates unless the SEC has issued an order approving the terms of the offer or the offer complies with SEC rules governing exchange offers. Rule 11a-2 permits an offer to exchange one variable annuity contract for another variable annuity contract of the same or an affiliated insurer without obtaining SEC approval, subject to requirements designed to address concerns about the imposition of additional sales charges. Specifically, the rule requires that: (i) no surrender charge be deducted at the time of the exchange; and (ii) if both the old and new contracts are subject to surrender charges, then, in computing the surrender charge for the new contract, the insurer must credit the period during which the contract owner held the old contract. Alternatively, insurance companies must comply with the so-called "retail exception," which was the subject of an SEC staff letter issued in June 2001. The letter provides a list of factors to be considered in determining whether the retail exception is available, and, in effect, promotes a facts and circumstances test. The industry struggles with the practicalities of applying

such a test, as well as with the competitive disadvantage created by the inapplicability of section 11 to exchanges of contracts between unaffiliated companies.

Both the states and the SEC oversee administration through on-site examinations and audits, among other things. The states also oversee this area through their review of customer complaints.

§ 1:5.4 Product Distribution

[A] Background

Entities and their salespersons that distribute variable insurance products are required to satisfy insurance and securities licensing requirements. While the provisions concerning insurance licensing requirements are the province of state insurance laws, the Securities Exchange Act of 1934 (the "Exchange Act") and the Financial Industry Regulatory Authority (FINRA), formerly the National Association of Securities Dealers (NASD), regulations set forth the relevant provisions governing distribution under the federal securities laws.

Generally, state insurance laws require persons who solicit insurance products (including variable insurance) to be licensed as insurance agents. An individual selling such products generally obtains an agent's license in that person's state of residence or the primary state in which he or she does business. He or she must also obtain "nonresident" licenses in other states. In order to qualify for an agent license, an individual generally is required to satisfy an exam requirement, among other things. In addition to being licensed, an insurance agent is required to be appointed by the insurance company whose product he or she seeks to sell. Generally, companies perform a background check before appointing an agent. States vary as to when the appointment process must be completed. Some states require that the process be completed before an agent solicits the product, while others require appointment prior to sale, while still others require appointment prior to the payment of sales commissions to the agent.

In addition to the "insurance hat," an insurance agent selling variable products is required to wear another hat—that of a securities-licensed registered representative. A person seeking a securities license to sell variable products is required to register with FINRA and to pass a competency exam (for example, a Series 6 or Series 7 exam).

Insurance agents and securities registered representatives are typically associated with a legal entity. Generally, an insurance agent is associated with an insurance company or an insurance agency ("ABC Insurance Associates"). A securities registered representative is associated with a broker/dealer.

As a result, state insurance laws, the Exchange Act, and the FINRA rules subject individuals selling variable products and the firms with

which they are associated to a comprehensive regulatory framework covering everything from suitability and replacement activity to more operational activity, such as net capital requirements and reporting on financial conditions.

State securities laws play a much less significant role. As noted above, a large number of states except variable products from the definition of "security." As such, the Blue Sky laws generally do not reach broker/dealers and their associated persons whose business is limited exclusively to the sale of variable products.

State securities registration of variable product salespersons pursuant to the Blue Sky laws are encountered in a limited number of states in which such contracts are not excepted from the securities code. Some state insurance departments, while not requiring state securities registration, do require satisfaction of the state securities examination (the Series 63) in connection with the issuance of a state variable contract license. Also, there have been instances of state insurance departments requiring state securities registration, even though variable contracts are not "securities" under the applicable state securities laws.

[B] FINRA Regulation

[B][1] Generally

FINRA imposes an extensive regulatory framework on its broker-dealer member firms selling variable products. FINRA's framework is multi-dimensional, and is comprised of comprehensive rules regulating members' conduct, a robust examination and enforcement program, and an educational and compliance outreach program.

FINRA member firms are subject to rules that cover every facet of a firm's business including:

- membership;
- suitability and sales practices;
- payment of compensation;
- handling of customer complaints;
- review, content, and filing of marketing communications; and
- establishment of a supervisory system and internal compliance program.

FINRA supplements its rulemaking with a robust examination and enforcement program. Recently, these programs have placed particular emphasis on variable annuity sales.

FINRA was created in July 2007 through the consolidation of the National Association of Securities Dealers, Inc.'s (NASD) and the New York Stock Exchange's (NYSE) departments regulating its

members. Today, FINRA is the largest self-regulatory organization (SRO) for securities firms doing business in the United States, overseeing nearly 5,000 brokerage firms. It operates from main offices and through fifteen district offices around the country.

FINRA's role in the securities industry grows out of the Exchange Act, which provides that direct, day-to-day regulatory authority over broker-dealers is carried out by SROs. While the day-to-day oversight of broker-dealers is conducted by FINRA, the SEC exercises oversight responsibility by approving FINRA rules and rule changes, examining FINRA, and reviewing FINRA actions and determinations.

[B][2] Requirements Governing the Suitability of Variable Annuity Transactions

FINRA has a comprehensive framework designed to ensure that firms have robust processes to determine the suitability of variable annuity transactions. FINRA Rule 2330 (formerly, NASD Rule 2821) is a targeted rule applying to variable annuity transactions. It supplements FINRA Rule 2111 (formerly, Rule 2310), the general suitability rule. In addition, FINRA has published guidance with respect to variable annuity exchanges. Each of these are discussed below, in turn.

[B][2][a] NASD's Suitability Rule Applying to Recommended Transactions—FINRA Rule 2111

FINRA Rule 2111 require securities firms or associated persons to have reasonable grounds for believing that a recommended transaction or investment strategy is suitable for that customer. This rule applies to all securities, including variable annuities. Under Rule 2111, in recommending a security, a broker-dealer must meet the requirement of reasonable basis suitability; customer-specific suitability; and quantitative suitability.[5] The concept of reasonable basis suitability places an obligation on broker-dealers to have an adequate and reasonable basis for a recommendation, regardless of the customer to whom the recommendation is made. To discharge its reasonable basis suitability obligation, a member must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards.

Customer-specific suitability refers to a broker-dealer's obligation to tailor a recommendation to a customer's financial profile and investment objectives. Thus, a broker-dealer may not recommend a security unless it believes that the security is appropriate for the customer

5. NASD Notice to Members 01-23 established broad criteria for determining whether a customer communication is a recommendation subject to suitability requirements, and covers online communications.

based upon the information that the broker-dealer has obtained from the customer.[6]

Quantitative suitability refers to a broker-dealer's obligation to have a reasonable basis to believe that a series of recommended strategies is not excessive when viewed in the aggregate.

Rule 2111 also provides for certain information which, a broker-dealer or associated person must make reasonable efforts to obtain including:

- the customer's financial status;
- the customer's tax status;
- the customer's investment objectives; and
- such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

[B][2][b] Guidance Concerning Variable Annuity Exchanges

As noted above, Rule 2330 imposes comprehensive requirements regarding variable annuity exchanges. In addition to these requirements, FINRA has provided securities firms with additional guidance regarding such exchanges.

First, specific guidance has been provided regarding exchanges of variable annuities into equity indexed annuities. In Notice to Members 05-50 (August 2005), FINRA reminds members that all recommendations to liquidate or surrender a registered security such as a mutual fund, variable annuity, or variable life contract must be suitable, including where such liquidations or surrenders are for the purpose of funding the purchase of an unregistered equity indexed annuity.

Notice to Members 07-06 ("NTM 07-06") expresses FINRA's concerns about replacements of variable annuities and other products in the context of registered representatives switching firms. NTM 07-06 deals with the general situation where a registered representative who has switched firms faces impediments in continuing to sell or service variable products to his or her existing client base. NTM 07-06 notes that in such situations, the representative may be tempted to cause his or her existing clients to replace their mutual fund and variable annuity holdings with new products offered by his or her new firm. NTM 07-06 states that such replacements must be suitable based on the customer's investment needs.

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6. *See, e.g.*, FINRA Regulatory Notice 07-43 and NASD Notice to Members 05-59.

NTM 07-06 states that in determining suitability a firm may consider the fact that it lacks a dealer or servicing agreement with the product sponsor and, therefore, the representative cannot provide the customer with ongoing service. However, the suitability consideration must also include other factors, such as whether the existing fund or variable product is subject to a contingent deferred sales charge and the fees and expenses associated with the new product being recommended. NTM 07-06 calls for firms to maintain procedures that are specifically designed to prevent problematic transactions recommended by newly transferred representatives.

[B][3] Controls Over Marketing Material: Review, Content, and Filing Requirements

FINRA Rules include extensive requirements for communications used by securities firms and their registered representatives. Firms' "Retail Communications" are required to comply with specific content standards, internal approval, and filing requirements. Among other things, such communications must be fair and balanced, may not omit any material fact, and may not predict or project performance.[7]

In addition to these content standards, FINRA rules require that, prior to use, all Retail Communications must be reviewed and approved by a registered principal of the broker-dealer. Further, Retail Communications must be filed with FINRA. FINRA staff reviews filed sales material and informs firms whether the material submitted complies with the cited rules, any changes that are necessary to bring the material into compliance, and, if applicable, FINRA staff provides an explanation why the material should not be used.

FINRA has set forth additional standards that must be considered with respect to variable products. NASD IM 2210-2 establishes guidelines for advertisements and sales literature for variable life insurance and variable annuities. The guidelines discuss how all communications must clearly describe the product as either a variable life insurance policy or a variable annuity. There must also be no representation or implication that these types of securities are short-term, liquid investments. Presentations regarding liquidity must be clear and balanced, describing the negative impact of early redemption. The safety resulting from guarantees on these products must not be overemphasized or exaggerated.

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7. FINRA Rule 2210.

[B][4] Requirement to Adopt and Implement a Supervisory System Over Sales Activity

The NASD Rules provide detailed standards and requirements with respect to a firm's supervision of sales. NASD Conduct Rule 3010 requires firms to establish and maintain a system to supervise the activities of registered representatives and associated persons that is reasonably designed to achieve compliance with applicable securities laws and regulations and the NASD Rules.

[B][4][a] Written Supervisory Procedures

A firm is required to establish and maintain written procedures for the supervision of each type of business the member maintains and for the supervision of its registered representatives and associated persons. The procedures are required to set forth the supervisory system established by the firm, including the titles, registration status, and location of all supervisory personnel, and the responsibilities of each supervisory person as they relate to the firm's business, the securities laws, and NASD Rules.

[B][4][b] Chain of Supervision

A firm is required to maintain a written record (commonly referred to as the "chain of supervision") showing the immediate supervisor for each registered representative and associated person.

[B][4][c] Approval of Transactions

A firm is required to follow certain review procedures to ensure supervision of transactions. Securities transactions must be endorsed by a registered principal, and a firm's accounts may be accepted only by an officer or manager at an Office of Supervisory Jurisdiction (OSJ).

[B][4][d] Approval of Correspondence

Firms are required to establish procedures for the review by a registered principal of incoming and outgoing written and electronic correspondence of their registered representatives with the public relating to its securities business.

[B][4][e] Annual Compliance Meetings with Representatives

A firm is required to conduct annual meetings or interviews with registered representatives to discuss compliance matters relevant to the activities of the representatives.

[B][4][f] Office Designations

Firms are required to classify the various locations in which they or their associated persons carry out their activities, to identify supervisors for each such location, and to assign particular supervisory responsibilities to each location. In particular, each location has to be classified as either an OSJ, a branch office, or an unregistered location.

[B][4][g] Inspections

Firms are required to inspect each OSJ and supervisory branch at least annually. Non-supervisory branches must be inspected, at a minimum, every three years. Non-branch locations are required to be inspected on a regular, periodic basis.

[B][4][h] "Outside" Activities of a Representative

FINRA Rules set forth specific requirements with respect to registered representative activities that are outside the scope of the firm's business. Registered persons are prohibited from being employed by, or receiving compensation from, another person as a result of any business activities outside the scope of his relationship with the firm, unless he has provided prompt written notice to the firm. In addition, firms' associated persons are prohibited from participating in any manner in a private securities transaction, except with the approval or acknowledgment of the member. Further, if the person is to receive selling compensation from a private securities transaction, the firm is required to supervise the participation and record the transaction on its books and records.

[B][4][i] Continuing Education Requirements

Registered Persons must comply with continuing education requirements. FINRA's continuing education requirements contemplate two elements: a regulatory element and a firm element. The regulatory element entails an interactive computer course administered at FINRA-approved training and testing centers. The firm element requires firms to maintain a "continuing and current" education program for its registered representatives who have direct contact with customers in the conduct of the member's securities sales, trading, and investment banking activities, and for the immediate supervisors of such persons. Firms are required to evaluate and prioritize their training needs at least annually and develop a written training plan. Such plan must take into consideration a firm's size, organizational structure, scope of business activities, as well as regulatory developments and the performance of registered persons in the

regulatory element. The firm element is independent from and is not satisfied through the annual compliance meeting described above.

[B][5] Requirement to Establish an Effective Compliance Program

Firms are required to have formalized compliance programs. Each firm is required to designate a chief compliance officer and each firm's chief executive officer must certify *annually* to having in place a process to establish, maintain, review, modify, and test the firm's compliance policies and supervisory procedures.[8] Further, firms are required to establish internal controls that include processes to independently test and verify the firm's supervisory system.[9]

[B][6] Controls Over Compensation

A number of FINRA rules regulate compensation practices for variable contracts. More specifically, certain provisions focus primarily on non-cash compensation arrangements and prohibit a firm or associated person from receiving any non-cash compensation arrangements, except in certain specified situations.[10] The rules contain exceptions for small gifts and occasional meals and entertainment, certain training and educational meetings, and certain incentive-based arrangements based on total production of an associated person with regard to variable contracts where credit given for each contract is equally weighted.

[B][7] Examinations and Enforcement

In order to verify broker-dealer compliance with FINRA rules and the federal securities laws, FINRA conducts an active inspection program. From FINRA's standpoint, examinations serve a fundamental regulatory purpose, that is, to cause widespread, consistent compliance with the investor protection standards embodied in the securities laws. From a broker-dealer's perspective, examinations serve as a constant reminder that a firm must have in place up-to-date compliance systems, policies, and procedures that cover all of its business lines. Firms that fail to comply with NASD Rules may be subject to disciplinary action.

Securities firms generally are examined on a "cycle" basis that ranges from annually to once every four years, depending on the firm's business activities, methods of operation, types of products sold, and disciplinary history. These exams are referred to as "routine" exams.

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8. FINRA Rule 3130.
9. NASD Conduct Rule 3012.
10. FINRA Rule 2320.

Routine examinations of members selling variable annuities will typically focus on, among other things:

- the review of the firm's supervisory structure;
- case file reviews to assess the suitability of variable annuity sales, including not only the appropriateness of the recommended contract, but also the appropriateness of any additional features or benefits;[11]
- suitability considerations regarding recommendations made by newly associated registered representatives to replace mutual funds or variable annuities;
- customer complaints;
- the effectiveness of the firm's surveillance efforts to review inappropriate activity; and
- unusual account activity.

In addition to routine exams, FINRA also conducts:

- "For cause" exams. Conducted in response to customer complaints, terminations of associated persons for cause, and other events.
- "Branch" exams. Examine high-risk branches for compliance with rules related to trading and market conduct.
- "Sweep" exams. Coordinated set of exams regarding practices, products, or areas of interest that cut across the industry.[12]

Over the past few years, a number of FINRA's sweep examinations have focused on variable annuity sales practices. One such sweep was conducted in 2004.[13] Another sweep looked at exchanges from variable annuities into equity indexed annuities. The sale of variable annuities is also being reviewed in a current sweep involving sales to seniors.[14]

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11. FINRA, ROUTINE EXAMS: IMPROVING EXAMINATION RESULTS (May 2007). In Notice 07-43, FINRA noted that examiners are closely looking at withdrawal penalties or other limits on liquidity, such as deferred variable annuities and equity indexed annuities, and variable life settlements.
12. FINRA, WHAT TO EXPECT: PREPARING FOR AN NASD ROUTINE EXAMINATION (Webcast Oct. 23, 2007).
13. Mary L. Schapiro, Vice Chairman, NASD, Remarks at the NASD Fall Conference (Oct. 14, 2004).
14. *Elderly Investment Fraud, Hearing Before the S. Comm. on Aging*, 109th Cong. (Mar. 29, 2006) (statement of Elisse B. Walter, Executive Vice President Regulatory Policy and Oversight, NASD). This sweep is being coordinated with the SEC and state securities regulators.

FINRA has wide-ranging enforcement authority to enforce the federal securities laws in addition to its own rules. FINRA's enforcement focus related to variable annuities has run parallel to the explosive growth of variable annuity sales over the past ten or so years. Where FINRA has determined there to be wrongdoing, it has not shied away from imposing stiff penalties and other types of sanctions against securities firms and associated persons. These cases have alleged various types of deficiencies, including inadequate supervision of sales of variable annuities and unsuitable sales to customers.[15]

[C] Group Variable Annuities—Regulation Under FINRA Rules

As noted above, certain group annuities designed specifically for the retirement plan marketplace are exempt from registration under the securities laws. Nevertheless, sales of exempted group annuities by registered representatives are subject to FINRA conduct rules.

Some background will be useful. Prior to 1993, FINRA was precluded from applying its conduct rules to transactions in exempted securities (as defined in section 3(a)(12) of the Exchange Act). As a result of the Government Securities Act Amendments of 1993, FINRA was permitted to apply its conduct rules to transactions in all exempted securities (except municipal securities). Practically speaking, this legislation gave FINRA authority to impose its sales practice rules to sales by FINRA member firms of exempt securities. FINRA followed the 1993 legislation with rulemaking to implement the additional authority to various types of exempt securities, including group variable annuities.

As a result, FINRA's Conduct Rules apply to sales of group variable annuities by FINRA member firms and their registered representatives. However, such rules do not apply to sales of group variable contracts by persons who are not registered with a FINRA member firm.

§ 1:5.5 Marketing

[A] Generally

Like other financial and insurance products, variable insurance products are generally marketed by oral statements made by salespeople and by written material. While oral statements are generally

15. *See* Letter from James S. Wrona, Associate Vice President and Associate General Counsel, FINRA, to Nancy M. Morris, Secretary U.S. Securities and Exchange Commission (Aug. 13, 2007) (summarizing recent FINRA enforcement cases involving variable annuities).

subject to broad standards under the law, written material is governed by a more specific framework derived from various sources. The primary challenge for legal and compliance personnel in reviewing written material relating to variable insurance products is to untangle an overlapping regulatory scheme.

At the federal level, variable insurance product marketing material is subject to the same securities law regulatory framework that regulates mutual funds. In some instances, this framework has been adapted to account for the differences between mutual funds and variable products. Generally, at the state level, such marketing material is regulated under general provisions governing traditional insurance products.

[B] SEC Rules

While an investment company is registered under the Investment Company, its securities are registered under the Securities Act. The Securities Act has a very strict framework governing written communications used in the sale of securities. In particular, written offers relating to securities must satisfy the requirements of sections 2(10), 5, and 10 of the Securities Act, which generally provides that such written offers must either meet the standards of a prospectus or be excepted entirely from the definition of a prospectus.

In short, what has developed is a structure where investment company marketing material must fall within one of three categories to avoid being subject to the full array of rules that govern a statutory prospectus. Two categories of advertisements may be used, as well as a category called "supplemental sales literature."

The two types of advertisements that may be used to market investment company shares are Rule 482 omitting prospectuses, and Rule 135a generic advertisements.

Rule 482 provides funds with a great degree of flexibility with respect to both content and form. Virtually any information may be presented, so long as it is not false or misleading. Notably, Rule 482 ads may show performance information. If total return performance is shown, the rule generally requires uniformly calculated one-year, five-year, and ten-year average total return quotations (typically referred to as "standardized performance"). Nonstandardized performance information may also be included, if accompanied by standardized performance. In addition, standardized yield information may be shown, but not non-standardized yield. If performance information is included, the ad must also include certain cautionary disclosures. A Rule 482 advertisement is not permitted to include or be accompanied by a purchase application.

Generic advertisements, permitted by Rule 135a, are allowed to contain only general information about investment company securities, not information about a particular investment company. Generic

advertisements are not as popular as Rule 482 advertisements because they are limited to providing only very general information about investment company securities.

In addition to the two categories of advertisements discussed above, communications that are "preceded or accompanied by" a statutory prospectus are permitted to be used as marketing communications. This type of communication is referred to as "supplemental sales literature" and is excepted from the definition of a prospectus. Supplemental sales literature may include a wide range of material. In contrast to Rule 482 ads, which are restricted to including only the performance information specified in the rule, supplemental sales literature can include other performance information. Nonstandardized performance must be accompanied, with equal prominence, by standardized performance numbers.

[C] FINRA Rules

In addition to the SEC regulations governing investment company advertisements and supplemental sales literature, these communications are generally subject to FINRA rules. This is because broker-dealers selling investment company shares are typically members of FINRA and, therefore, subject to its rules which (among others things) apply to investment company marketing material. The primary rule in this area is FINRA Rule 2210, which establishes standards regarding the content of communications and the circumstances under which material must be filed with FINRA.