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News and Analysis of the Annuity and Variable Life Industries

Sub-Accounts = Black Hole of Compliance

By John J. Duval, Sr.

The **NASD** is a self regulatory organization with a very thick manual of rules and regulations. Even so, some gaps in supervision exist, especially when dealing with complicated products like variable annuities and variable life insurance. Often, people simplistically describe them as "mutual funds in an insurance wrapper," but this only touches on the profound difference between the mutual fund and variable product sales and supervision process.

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As required by Rule 3010 (a) (see sidebar), most broker-dealers have instituted procedures to review and approve each and every daily stock and mutual fund transaction performed by their salesmen. The review is designed to "flag" those trades that are outside of their system-wide parameters set up by their compliance departments. These systems penetrate to the level of the individual investor.

For example, investors whose new account form was marked conservative or moderate would have their accounts flagged when a trade comes through the system that did not conform to the customer's assigned risk tolerance and investment objective. Each branch manager, sales supervisor or compliance supervisor would then judge how to respond: merely talk to the broker, send the client a "happy" letter (a friendly inquiry to verify the customer's wishes) or exercise the best practice by calling the client.

The problem is that most member firms have no similar compliance procedure or safeguard for variable product sub-accounts. The variable annuities market, for example, has grown to total assets of $1.1 trillion (12/31/04) and it now represents a quarter to one-third of the overall business for many small- and medium-sized broker-dealers. This market has also grown exponentially at large wirehouses as well as with registered investment advisers.

The NASD has sent out numerous Notices to Members warning them about the potential sales abuses of these products. For example, a May 1999 notice entitled, "The NASD Reminds Members of Their Responsibilities Regarding the Sales of Variable Annuities," states, "members should consider supplementing their procedures to ensure that they will be adequately designed to achieve compliance with legal and regulatory requirements." This same Notice goes further into detail about the point of this editorial: "the registered representative and a registered principal should review the customer's investment objectives, risk tolerance, and other information to determine that the variable annuity contract as a whole and the underlying sub-accounts recommended to the customer are suitable [emphasis added]."

With this in mind, and putting into practice the NASD requirement above, the issue of compliance has fallen into a black hole when an investor's assets move from one variable sub-account to another. Practically, since the contract is "held" by the insurance carrier, an exchange between these sub-accounts does not show up on the "daily run" at the branch and the confirmation notices for the exchanges within sub-accounts go to the registered representative and a copy to the contract holder. But how does the firm's branch manager, home office compliance department, or anybody, know what is taking place? And, if they do, what is their procedure for monitoring suitability for the exchange?

Perhaps more troubling, the problem also exists when the broker/dealer

NASD Rule 3010 (a)

Supervisory System: "Each member shall establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of this Association. Final responsibility for proper supervision shall rest with the member."

should be able to monitor suitability. Sometimes, even initial sub-account enrollments that don't match up with the client's new account agreement are missed or ignored by the branch manager, such as aggressive sub-accounts in a variable contract for a client whose new account agreement says "moderate." At the time of this writing only a few firms have begun to address either of these problems.

I'll give you a real life example. I recently testified as an expert witness in a case involving an elderly widow who was sold a substantial variable annuity that represented the lion's share of her net worth (the source of funding was a replacement from an older variable annuity, but that's another issue). This investor was formerly a CD-only investor and her initial allocation was in only three equity sub-accounts with no fixed accounts as part of her asset allocation. Then, you guessed it, the investment was at the height of the bubble, March, 2000. After suffering an immediate, large loss, the broker, in an effort to "double up and catch up," with discretion ("telephone authority" allowed in the variable annuity application), moved the client into the ProFund Ultra OTC fund sub-account. The prospectus describes this sub-account as principally invested in "options and futures." The predictable happened: a financial debacle for that unknowing and unsophisticated investor. Of interest, the brokerage firm in this case provided a defense based on the fact that since only a few firms have an adequate compliance system, they should not be faulted as they were in the mainstream of industry standards. Imagine!

Now, why wasn't this firm able to monitor the client's suitability? Why didn't the office manager, home office supervision, or anybody step in and tell the registered representative and the client that this was a reckless move, totally inappropriate, and unsuitable for her moderate risk tolerance? The answer is they did not have a procedure in place to intercede and supervise.

However, it would not be fair to simply present a problem without a solution. There are many, but here are two:

(1) at smaller firms, require the registered representatives to supply the confirms they receive from the insurance company to their branch manager and then simply mail copies of the sub-account exchange confirmations to their home office compliance departments. Costs: an envelope and a stamp.

(2) put more people in place to monitor the exchanges.

Yes, the latter method would mean higher overhead and costs. But won't the savings be more than offset by fewer arbitrations?

Unfortunately, it may take a whopping punitive damage award in an NASD arbitration to send the industry a message that the financial services providers need to start complying with their own industry rules and put in a procedure to help protect the investor, which is why the NASD is there in the first place. Speaking of procedures, as an analogy, I am reminded what Gandhi said about Christianity. To paraphrase: it's a wonderful religion, it's too bad they don't practice it. amn

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