CARLTON FIELDS

FINRA Trumpets Variable Annuity Sales Problems While SEC Falls Silent

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FINRA's report on its broker-dealer examination findings for 2018 features a substantial discussion of "Unsuitable Variable Annuity Recommendations." This is in sharp contrast with FINRA's 2017 report, which didn't mention variable insurance products at all. It also contrasts with the SEC's Office of Compliance Inspections and Examinations (OCIE) 2019 exam priorities, which, for the first time in some years, does not specify variable insurance products.

FINRA has adopted a practice of annually publishing its observations made in the course of its broker-dealer examinations. One purpose of the report is to help FINRA-member firms refine their compliance policies and procedures. FINRA's most recent report, published last December, addresses a number of perceived problems:

- **Supervision**. Some firms failed to ensure that reps' recommendations of variable annuities complied with suitability obligations. A number of firms lacked adequate supervisory systems and written supervisory procedures. Other firms had such systems and procedures, but failed to maintain and enforce them.

- **Exchanges**. Some firms allowed unsuitable and largely unsupervised rep-driven recommendations to exchange variable annuities. Some exchanges were inconsistent with the customer's objectives and time horizon. Other exchanges resulted in increased fees or loss of accrued benefits. These results occurred when reps effected transactions directly with the life insurance company.

- **Purchase Funds**. Some reps concealed the source of funds used to buy new variable annuities. The reps had customers take direct receipt of monies from existing securities or annuities. This created the appearance of un-invested cash being used for purchase payments. The practice may have resulted in unfavorable tax consequences for the customer.

- **Training**. Some firms did not adequately train reps selling variable annuities and supervisors overseeing variable annuity transactions. Some reps misrepresented the cost of variable annuity riders through disclosure forms. Other reps lacked knowledge of how to evaluate fees, surrender charges, and long-term income riders, particularly in the context of variable annuity exchanges. Some supervisors appeared to focus on exchange form completion, rather than the substantive factors involved in the customer's decision.
- **Annuity Data**. Some firms appear to have inaccurate and incomplete data for annuity products. This includes general product information, as well as information on share class, riders, and exchange-based activity.

By contrast, for the first time in some years, OCIE has not listed variable insurance products as an exam priority. Over the last seven years, with the exception of 2015, OCIE has announced that at least variable annuities, if not variable life insurance, have been an exam priority.

OCIE's focus on variable insurance products has shifted over the years. In 2012, the exam priority was "new channels of distribution"; in 2013, "hedge fund investment strategies in variable annuity structures"; and in 2014, insurance company "buybacks." After 2015, OCIE's focus shifted to marketing. In 2016, the focus was on "suitability," and, in 2017 and 2018, "sales."

However, OCIE did state that, in examining broker-dealers and investment advisers, it would focus on "the services and products offered to … those saving for retirement," which may well include variable insurance products.

OCIE said that it would "conduct examinations that review how broker-dealers oversee their interactions with senior investors, including their ability to identify financial exploitation of seniors." OCIE explained that "[t]hese examinations will focus on, among other things, compliance programs of investment advisers, the appropriateness of certain investment recommendations to seniors, and the supervision by firms of their employees and independent representatives."

OCIE gave no reason for omitting specific reference to variable insurance products from its 2019 exam priorities. One possible reason is the perceived emphasis that the Trump administration places on educating, rather than bringing enforcement actions against, industry regarding regulation. Another possible reason is that the life insurance industry has moved into the SEC's regulatory mainstream and no longer requires continuous monitoring of what has been unfamiliar to the agency for so many years.

Still another possibility is that the SEC, having shifted some broker-dealer examiners to investment adviser inspections, will be relying more on FINRA to address variable annuities during its broker-dealer examinations.

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