Variable Contracts 20.00

Introduction

A variable annuity is an insurance contract that is subject to regulation under state insurance and securities laws. Although variable annuities offer investment features similar in many respects to mutual funds, a typical variable annuity offers three basic features not commonly found in mutual funds: (1) tax-deferred treatment of earnings; (2) a death benefit; and (3) annuity payout options that can provide guaranteed income for life.

A customer's premium payments to purchase a variable annuity are allocated to underlying investment portfolios, often termed sub-accounts. The variable annuity contract may also include a guaranteed fixed interest sub-account that is part of the general account of the insurer. The general account is composed of the assets of the insurance company issuing the contract. The value of the underlying sub-accounts that are not guaranteed will fluctuate in response to market changes and other factors. Because the contract owners assume these investment risks, variable annuities are deemed to be securities products and generally must be registered under the Securities Act of 1933.

The underlying sub-accounts that are not guaranteed are funded by a separate account of a life insurance company that, absent an exemption, is required to be registered as an investment company under the Investment Company Act of 1940. Variable annuities assess various fees including fees related to insurance features (e.g., lifetime annuitization and the death benefit) which are typically deducted from customer assets in the separate account

A distributor of variable annuity contracts to individuals is required to register as a broker/dealer under the Securities Exchange Act of 1934 and become a member of FINRA. The distribution of variable annuity contracts is subject to FINRA rules.

Variable life insurance, which has either a single premium or flexible premium structure, is similar to straight or whole life insurance in that it has cash values. Those cash values, however, are typically invested in various underlying investment portfolios, commonly known as sub-accounts. The insurer guarantees a minimum death benefit regardless of portfolio performance, although excess gains buy additional coverage. The attraction of this particular product is capital growth opportunity.

20.01 Licensing and Qualification Requirements

The Firm has established set guidelines to ensure that only registered personnel are authorized to engage in activities involving the sale of variable contract products. For example, the Firm's designated supervisor is responsible for reviewing and monitoring all registered personnel and associated persons to ensure that they are properly registered with the appropriate securities and/or insurance licenses.

To offer variable products, a registered representative must meet the following licensing requirements:

- FINRA Registration (e.g. Investment Company/Variable Contracts Representative- Series 6 or General Securities Representative- Series 7 license);
- Securities license in the state where the policy owner resides and the state in which the application is signed;
- Life insurance and variable annuity license issued by the department of Insurance in the state where the policy owner resides and the state where the application is signed;
- Company appointment by the issuer of the product. ►►

Implementation Strategy

Upon employment of each registered person, the designated principal will review each employee's license and registration information, such as Form U-4/U-5, to ensure that he/she has the proper registrations for the type business that shall be conducted.

20.02 Customer Suitability

The Firm is required to make all reasonable efforts to obtain information concerning a customer's financial and tax status, investment objectives, and such other information used or considered in making recommendations to the customer. When recommending variable annuity products, the Firm should make reasonable efforts to obtain the following customer information:

- the customer's occupation;
- marital status;
- age;
- number of dependents;
- investment objectives;
- risk tolerance;
- tax status;
- previous investment experience;
- liquid net worth;
- source of funds for investment;
- other investments and savings; and
- annual income.

In accordance with *NTM 99-35*, each time a variable annuity transaction is recommended to a customer, the registered representative and a registered principal of the Firm will 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. The registered principal should compare the information in the account application with other relevant information sources, e.g., an account information form, to check for apparent accuracy and consistency prior to approving the transaction.

Liquidity

Lack of liquidity, which may be caused by surrender charges or penalties for early withdrawal under the Internal Revenue Code, may make a variable annuity an unsuitable investment for customers who have short-term investment objectives. Moreover, although a benefit of a variable annuity investment is that earnings accrue on a tax-deferred basis, a minimum holding period is often necessary before the tax benefits are likely to outweigh the often higher fees imposed on variable annuities relative to alternative investments, such as mutual funds.

Therefore, registered representatives of the Firm should inquire about whether the customer has a long-term investment objective and only recommend a variable annuity if the customer has long-term investment objectives. In general, registered representatives of the Firm should make sure that the customer understands the effect of surrender charges on redemptions and that a withdrawal prior to the age of 59 1/2 could result in a withdrawal tax penalty. In addition, the registered representatives should make sure that customers who are 59 1/2 or older are informed when surrender charges apply to withdrawals. ►►

Implementation Strategy

Each time a variable annuity transaction is recommended to a customer, the

designated principal will ensure that the registered representative made all reasonable efforts to obtain all relevant information considered in making recommendations to the customer. Additionally, the designated supervisor will review the customer's investment objectives, risk tolerance, and other information to determine that the variable annuity contract, and the underlying sub-accounts recommended to the customer are suitable. The designated principal will compare the information in the account application with other relevant information sources (e.g., an account information form) to check for apparent accuracy and consistency prior to approving the transaction.

Additionally, the designated principal will screen for any customer whose age may make a long-term investment inappropriate, such as any customer over a specific age (e.g. 65 years old). Based on certain contract features, some customers of advanced age may be unsuitable for a variable annuity investment.

Note: Please see the Order Instructions & Explanation of Your Investment Variable Annuity Initial Purchase form for further details.

Supervision of Recommendations after a Registered Representative Changes Firms

Registered representatives with an established customer base may, from time to time, change their association from one firm to another and may wish to bring with them customer assets, including variable annuity products. When a representative who has sold such a product chooses to associate with a new firm, however, there may be impediments to the representative's ability to continue selling or servicing these investments, as well as receiving trail commissions from the sponsor for products the representative previously sold or serviced.

In these situations, the transferring representative may be tempted to recommend to customers that they replace their existing variable annuity products with other investments, without adequately considering the customer's best interests and the suitability for the customer of those recommendations. Such inappropriate recommendations might be premised upon the fact that the new firm or the representative will no longer receive trail commissions for the customer's current investments or that the representative will generate more income by replacing an investment than recommending that the customer continue to hold the investment through the representative's prior firm.

A recommendation to liquidate, replace or surrender an existing investment must be suitable and based upon the customer's investment needs and not the financial needs of the firm or its associated persons. A firm may consider the fact that the firm lacks a dealer or servicing agreement with the product sponsor and, therefore, the registered representative cannot provide the customer with the service that the customer desires with respect to the product. The suitability analysis must also include other considerations, however, including whether the customer's variable product is subject to a contingent deferred sales charge or a required holding (surrender) period, or has other features that materially affect its value or liquidity, and the fees and expenses associated with the new product being recommended. (NTM 07-06; February 2007)

Implementation Strategy

In the event the Firm employs or otherwise associates with a new registered representative, the designated principal will perform the following functions:

- During the initial due diligence review, the designated supervisor will obtain information regarding the nature of the representative's business and the extent to which he or she offers investment products for which the Firm may need a dealer or servicing agreement in order for the representative to sell and provide service.

Note: In conducting reasonable due diligence of the prospective registered representative's customer base, the new firm needs to learn only the identity of the various mutual fund and variable products held by the registered representative's customer base. Detailed, nonpublic, personal information about individual customers and their particular investments is not necessary or relevant to meet the objectives of this review. Finally, it is incumbent upon firms to educate their prospective representatives in understanding that a change of employment is not by itself a suitable basis for recommending a switch from one product to another and to supervise with respect to such conduct. (Ref. Regulatory Notice 07-36; Issued Aug. 13, 2007)

- If the Firm is unable or unwilling to service a customer's variable annuity, the Firm will instruct the registered representative to advise the customer of this fact, as well as the options the customer may have to continue to hold the investment at the customer's prior firm, before recommending that the customer liquidate or surrender the investment.

- Any recommendation to liquidate, replace or surrender a variable annuity must be suitable for the customer based upon the customer's financial needs and investment objectives. Recommendations should not be a function of the desire of the Firm or its new representative to obtain compensation that it would not otherwise receive were the customer to retain the previously sold investment.

- The designated supervisor will review any replacements recommended by the associated person with a view to identifying any recommendations to liquidate or surrender variable products that may be inconsistent with the customer's investment needs and objectives or that have not been preceded by appropriate disclosure to the customer.

20.03 Customer Application Information

The registered representative should seek to ensure that the variable annuity application and any other information provided by the customer to the member is complete and accurate, and promptly forwarded to a registered principal for review.

When recommending variable annuity products, the Firm should make reasonable efforts to obtain the following customer information:

- the customer's occupation;
- marital status;
- age;
- number of dependents;
- investment objectives;
- risk tolerance;
- tax status;
- previous investment experience;
- liquid net worth;
- source of funds for investment;
- other investments and savings; and
- annual income.

Registered representatives of the Firm should document all of the aforementioned types of information in a customer account information form and should submit it with every variable contract application. The Firm's designated principal should review the account information form and verify that the

recommendation of both the policy and the sub-account allocation is consistent with the customer's investment objectives and risk tolerance.

Review of Customer Information

The Firm should consider whether the customer desires and needs the features offered through variable contracts. For variable life insurance, the Firm should consider whether the customer needs life insurance and whether the customer can afford the premiums likely needed to keep the policy in force. ►►

Implementation Strategy

The designated principal will review the account information form and verify that the recommendation of both the policy and the sub-account allocation is consistent with the customer's investment objectives and risk tolerance. All documentation reviewed will be filed in the appropriate customer file.

20.04 Disclosure Information

The Firm should discuss all relevant facts with the customer to including the following liquidity issues:

- potential surrender charges and IRS penalties;
- general fees;
- mortality and expense charges;
- administrative charges;
- investment advisory fees;
- any applicable state and local government premium taxes; and
- market risk.

Issuance of the Prospectus

A current prospectus should be given to each customer when a variable annuity is recommended. Prospectus information about important factors, such as fees and expenses and the lack of liquidity, should be discussed with the customer.

Note: Please see the Order Instructions & Explanation of Your Investment Variable Annuity Initial Purchase form for further details.

20.05 Tax Qualified Accounts

Some tax-qualified retirement plans (e.g., 401(k) plans) provide customers with an option to make investment choices only among several variable annuities. While these variable annuities provide most of the same benefits to investors as variable annuities offered outside of a tax-qualified retirement plan, they *do not* provide any additional tax deferred treatment of earnings beyond the treatment provided by the tax-qualified retirement plan itself.

In accordance with *NTM 99-35*, when a registered representative recommends the purchase of a variable annuity for any tax-qualified retirement account (e.g., 401(k) plan, IRA), the registered representative should disclose to the customer that the tax deferred accrual feature is provided by the tax-qualified retirement plan and that the tax deferred accrual feature of the variable annuity is unnecessary. The registered representative should recommend a variable annuity only when its other benefits, such as lifetime income payments, family protection through the death benefit, and guaranteed fees, support the recommendation.

As a result, the Firm will conduct a comprehensive suitability analysis prior to approving the sale of a variable annuity with surrender charges to a customer in a tax-qualified account subject to plan minimum distribution requirements.

20.06 Replacements

The Firm may decide to develop an exchange or replacement analysis document or utilize an existing form authorized by a state insurance commission or other regulatory agency. If such a document is used, then (consistent with the requirements of various states) it should be completed for all variable annuity replacements and should include an explanation of the benefits of replacing one contract for another variable contract. The document also should be signed by the customer, the registered representative, and the registered principal.

The registered representative and the registered principal of the Firm should determine, based on the information provided by the customer and their own knowledge of the product features, that replacing the existing contract with a new contract is suitable for the customer. Consideration should be given to such matters as product enhancements and improvements, lower cost structures, and surrender charges.

Under the vast majority of state insurance laws, a replacement occurs when a new insurance or variable contract is issued and the registered representative knows, or has reason to know, that, as a result of this transaction, an existing life insurance policy or annuity contract on the same life has been or will be:

- Lapsed;
- Surrendered partially, or in full;
- Borrowed against in any amount;
- Reduced in any amount;
- Changed to reduced paid-up insurance; or
- Changed into extended term insurance.

Most states have laws or regulations governing the replacement of insurance products. In addition to knowing and complying with the Firm’s existing policies and procedures governing replacements, each registered person is also responsible for knowing and complying with all applicable state replacement laws and regulations concerning replacements, including that portion of those laws and regulations which require a registered person to obtain state-mandated replacement forms and the client's signature as required.

Before recommending the replacement of an existing contract, a registered representative should give careful consideration to the possible consequences, including, without limitation to the following:

- Changes in age and health resulting in higher premiums;
- New sales loads and other expenses;
- Lower policy guarantees and assumption of additional risks by the client;
- Loss of important grandfather rights, if applicable;
- The issuer's right to challenge a death claim generally within two years from date of issue;

- Surrender or early withdrawal charges;
- Loss of potential policy enhancements;
- Income tax consequences;
- Loss of a lower policy loan interest rate and loss of other favorable policy provisions.

The Firm requires that each registered representative must provide a written explanation of the transaction and the reasons for the product selection on the appropriate variable product forms. Because there are a variety of reasons that a replacement may be appropriate for a client, some of the possible explanations are provided below:

- Client requires immediate benefits unavailable from current issuer;
- Higher rating of issuer;
- More favorable underwriting classification;
- Reduced costs to client;
- Loss of confidence in the existing insurer or its sales people;
- Estate planning;
- Higher guarantee rate;
- Dissatisfaction with current policy holder service or policy administration;
- Consolidation of coverage with one insurer;
- Ability to convert a heavily loaned policy into a new policy;
- Availability of new coverage or improved benefits/features;
- Historical premium funding of existing policy will not support current death benefit;
- Customer expressed need for increased coverage;
- Dissatisfaction with the current insurer's ratings;
- Dissatisfaction with the current insurer's claims policies, procedures and turnaround time;
- Ability to obtain the same or increased coverage without an increase in projected cost;
- Type of product needed has changed;
- Restructuring ownership and existing policy cannot be transformed to meet current needs;
- Ability to obtain cheaper coverage based on guaranteed values and benefits;
- Ability to obtain cheaper coverage based on illustrated non-guaranteed values and benefits;

- Dissatisfaction with the current insurer's dividend history;
- Better reputation, name recognition and/or rating with new insurer;
- Concern over adverse publicity relating to existing insurer;
- The current carrier was unable or unwilling to modify existing policy/annuity to meet the customer's objectives;
- Current carrier was unable or unwilling to match the new underwriting classification;
- Availability of additional or alternative investment sub-accounts;
- Unsolicited request by customer.

Although Replacements can be a legitimate part of selling life insurance and annuity products, the main focus is whether the replacement is appropriate for the client. Registered representatives are reminded that the Firm's primary concern is the well-being of the client and that one (or more) replacement sale failing to meet such standards may result in the refusal to accept the sale by the main office or, in extreme cases, disciplinary action.

Implementation Strategy

The designated principal will review transaction information, new account forms and *Order Instructions & Explanation of Your Investment Variable Annuity Initial Purchase* forms to ensure that annuity replacement transactions are suitable. All documentation reviewed will be filed in the appropriate customer file.

Note: Please see the Order Instructions & Explanation of Your Investment Variable Annuity Initial Purchase form for further details.

20.07 Sales Agreements

The Firm will enter into a sales agreement with the underwriters of any/all variable annuity contracts and variable life insurance policies that are to be offered by the Firm. The Firm's designated supervisor is responsible for maintaining copies of all sales agreements to be located at the Firm's principal place of business.

20.08 Prohibited Business Practices

In a recent FINRA disciplinary action, FINRA member firms were found to have violated *Rule 3010* (Supervision) for failing to establish, maintain, and enforce reasonable supervisory procedures. The member's procedures failed to adequately differentiate between fixed and variable life insurance products. In addition, the member was found to have violated FINRA Rule 2010 (formally NASD 2110) (Standards of Commercial Honor and Principles of Trade) for engaging in material misrepresentations and omissions, Rule 2210 (Communications with the Public) for the use of misleading sales literature, and Rule 2310 (Suitability Rule) for unsuitable recommendations and sales. The following is a list of some of the violations concerning variable life insurance products:

- Statements indicating that new policies could be acquired by customers already owning the firm's life insurance by using cash values or future dividends from customers' existing policies, for little or no additional cash payment;

- Statements indicating that the premium payments would end, or "vanish," after a certain number of years;
- Statements indicating that variable life policies were not insurance but were an investment, savings, or retirement plan;
- Unsuitable sales to customers, including retirees and persons who did not know that they were purchasing insurance or did not want life insurance;
- Failure to establish, maintain, and enforce adequate procedures with respect to the review of variable life insurance purchases to determine whether sales were suitable for customers and failure to obtain the customer information necessary to make suitability determinations;
- Use of misleading sales literature;
- Failure to establish, maintain, and enforce reasonable supervisory procedures;
- Failure to register representatives and principals and permitting unregistered persons to sell securities;

Additionally, the following is a list of prohibited business practices regarding the Firm's variable annuity business:

- Registered persons of the Firm may not conceal (or suggest or encourage the concealment) of any material facts that could affect the underwriting decision. However, each registered person has the obligation to disclose all information that may potentially affect the underwriting decision;
- Each registered representative is prohibited from changing the client's address on any account to reflect the registered person's own address, place of business, or any other address over which they exercise direct or indirect control;
- Each registered representative shall ensure that the client's check is made payable to the specific issuing company. Registered representatives are not permitted to receive third-party checks, starter checks or any other checks deemed not to be acceptable to the issuing company;
- Each registered representative is prohibited from submitting applications on behalf of themselves, family members or other customers knowing that they will be rescinded or lapsed after the qualification period;
- Each registered representative is prohibited from engaging in any other unethical conduct for the purposes of qualifying for a prize, reward or other type of compensation structure;
- Each registered representative is prohibited from disclosing any personal, medical, financial or any other non-public information on an any client or prospective client to a unauthorized third-party entity;
- Each registered representative is prohibited from signing a client's name to a check, application, replacement form, loan request form, policy receipt or any other relevant document of the Firm's use;

- Each registered representative is prohibited from guaranteeing future performance on any product;
- Each registered representative is prohibited from designating him/her self as a contract beneficiary without prior approval except in family situations;
- Registered representatives may not sell or attempt to sell any securities or insurance products from companies that are not approved by the Firm.

20.09 Communications with the Public

Communications with the Public About Variable Life Insurance and Variable Annuities

The standards governing communications with the public are set forth in Rule 2210. In addition to those standards, the following guidelines must be considered in preparing advertisements and sales literature about variable life insurance and variable annuities. The guidelines are applicable to advertisements and sales literature as defined in Rule 2210, as well as individualized communications such as personalized letters and computer generated illustrations, whether printed or made available on-screen.

General Considerations

Product Identification

All communications must clearly describe the product as either a variable life insurance policy or a variable annuity, as applicable. Member firms may use proprietary names in addition to this description. In cases where the proprietary name includes a description of the type of security being offered, there is no requirement to include a generalized description. For example, if the material includes a name such as the "XYZ Variable Life Insurance Policy," it is not necessary to include a statement indicating that the security is a variable life insurance policy. Considering the significant differences between mutual funds and variable products, the presentation must not represent or imply that the product being offered or its underlying account is a mutual fund.

Liquidity

Considering that variable life insurance and variable annuities frequently involve substantial charges and/or tax penalties for early withdrawals, there must be no representation or implication that these are short-term, liquid investments. Presentations regarding liquidity or ease of access to investment values must be balanced by clear language describing the negative impact of early redemptions. Examples of this negative impact may be the payment of contingent deferred sales loads and tax penalties, and the fact that the investor may receive less than the original invested amount. With respect to variable life insurance, discussions of loans and withdrawals must explain their impact on cash values and death benefits.

Claims About Guarantees

Insurance companies issuing variable life insurance and variable annuities provide a number of specific guarantees. For example, an insurance company may guarantee a minimum death benefit for a variable life insurance policy or the company may guarantee a schedule of payments to a variable annuity owner. Variable life insurance policies and variable annuities may also offer a fixed investment account which is guaranteed by the insurance company. The relative safety resulting from such a guarantee must not be overemphasized or exaggerated as it depends on the claims-paying ability of the issuing insurance company. There must be no representation or implication that a guarantee applies to the investment return or principal value of the separate account. Similarly, it must not be represented or implied that an insurance company's financial ratings apply to the separate account.

Specific Considerations

Fund Performance Predating Inclusion in the Variable Product

In order to show how an existing fund would have performed had it been an investment option within a variable life insurance policy or variable annuity, communications may contain the fund's historical performance that predates its inclusion in the policy or annuity. Such performance may only be used provided that no significant changes occurred to the fund at the time or after it became part of the variable product. However, communications may not include the performance of an existing fund for the purposes of promoting investment in a similar, but new, investment option (i.e., clone fund or model fund) available in a variable contract. The presentation of historical performance must conform to applicable FINRA and SEC standards. Particular attention must be given to including all elements of return and deducting applicable charges and expenses.

Product Comparisons

A comparison of investment products may be used provided the comparison complies with applicable requirements set forth under Rule 2210. Particular attention must be paid to the specific standards regarding "comparisons" set forth in Rule 2210(d)(2)(B).

Use of Rankings

A ranking which reflects the relative performance of the separate account or the underlying investment option may be included in advertisements and sales literature provided its use is consistent with the standards contained in IM-2210-3.

Discussions Regarding Insurance and Investment Features of Variable Life Insurance

Communications on behalf of single premium variable life insurance may emphasize the investment features of the product provided an adequate explanation of the life insurance features is given. Sales material for other types of variable life insurance must provide a balanced discussion of these features.

Hypothetical Illustrations of Rates of Return in Variable Life Insurance Sales Literature and Personalized Illustrations

Hypothetical illustrations using assumed rates of return may be used to demonstrate the way a variable life insurance policy operates. The illustrations show how the performance of the underlying investment accounts could affect the policy cash value and death benefit. These illustrations may not be used to project or predict investment results as such forecasts are strictly prohibited by the Rules. The methodology and format of hypothetical illustrations must be modeled after the required illustrations in the prospectus.

An illustration may use any combination of assumed investment returns up to and including a gross rate of 12%, provided that one of the returns is a 0% gross rate. Although the maximum assumed rate of 12% may be acceptable, members are urged to assure that the maximum rate illustrated is reasonable considering market conditions and the available investment options. The purpose of the required 0% rate of return is to demonstrate how a lack of growth in the underlying investment accounts may affect policy values and to reinforce the hypothetical nature of the illustration.

The illustrations must reflect the maximum (guaranteed) mortality and expense charges associated with the policy for each assumed rate of return. Current charges may be illustrated in addition to the maximum charges.

Preceding any illustration there must be a prominent explanation that the purpose of the illustration is to show how the performance of the underlying investment accounts could affect the policy cash value and death benefit. The explanation must also state that the illustration is hypothetical and may not be used to project or predict investment results.

In sales literature which includes hypothetical illustrations, member firms may provide a personalized illustration which reflects factors relating to the individual customer's circumstances. A personalized illustration may not contain a rate of return greater than 12% and must follow all of the standards set forth in subparagraph (A), above.

In general, it is inappropriate to compare a variable life insurance policy with another product based on hypothetical performance as this type of presentation goes beyond the singular purpose of illustrating how the performance of the underlying investment accounts could affect the policy cash value and death benefit. It is permissible, however, to use a hypothetical illustration in order to compare a variable life insurance policy to a term policy with the difference in cost invested in a side product. The sole purpose of this type of illustration would be to demonstrate the concept of tax-deferred growth as a result of investing in the variable product. The following conditions must be met in order to make this type of comparison balanced and complete:

- the comparative illustration must be accompanied by an illustration which reflects the standards outlined in subparagraph (A), above;
- the rate of return used in the comparative illustration must be no greater than 12%;
- the rate of return assumed for the side product and the variable life policy must be the same;
- the same fees deducted from the required prospectus illustration must be deducted from the comparative illustration;
- the side product must be illustrated using gross values which do not reflect the deduction of any fees; and,
- the side product must not be identified or characterized as any specific investment or investment type.►►

Implementation Strategy

The designated principal will review all relevant communications with the public (e.g. advertising and sales literature, etc.) involving variable contracts to ensure that the Firm is maintaining compliance with amended Rule 2210, 2211 and other relevant Interpretative Materials.

20.10 Variable Contract Delivery

Disclosure and Prospectus Delivery

The Firm or its designated registered representative is required to provide the customer with a current prospectus. NTM 04-45 proposes a rule that would require a separate, brief, “plain English” risk disclosure document highlighting the main features of the particular variable annuity transaction. Those features would include:

- liquidity issues, such as potential surrender charges and IRS penalties;

- sales charges;
- fees (including mortality and administrative fees, investment advisory fees and charges for riders or special features);
- federal tax treatment for variable annuities;
- any applicable state and local government premium taxes; and
- market risk.

The risk disclosure document would be required to inform the customer whether a “free look” period applies to the variable annuity contract, during which the customer could terminate the contract without paying any surrender charges and receive a refund of his or her purchase payments.

Additionally, no firm may deliver or issue for delivery variable contracts within the appropriate federal, state and SRO jurisdictions unless it is licensed or organized to do a variable life, annuity, or both, business in accordance federal, state and SRO rules and regulations. ►►

Implementation Strategy

The designated supervisor will review and approve each variable annuity transaction. The designated supervisor will consider specific factors (for instance, whether the customer’s age or liquidity needs make a long-term investment inappropriate).

Additionally, the designated principal will continuously monitor all relevant documentation pertaining to the Firm’s variable contract business to ensure that the Firm and each corresponding registered representative is properly licensed and meets all requisite qualifications to deliver, or issue for delivery such products in all relevant jurisdictions. In the event the Firm discovers an unauthorized delivery of a variable annuity, the designated supervisor will immediately investigate the incident. The designated supervisor will ensure that relevant documentation (and any corrective action if applicable) is filed in the customer account file as evidence of review.

20.11 Compensation for Variable Contracts

Except as described below, no associated person of the Firm shall accept any compensation from anyone other than the firm with which the person is associated. This requirement will not prohibit arrangements where a non-member company pays compensation directly to associated persons of the member, provided that:

- the arrangement is agreed to by the member;
- the member relies on an appropriate rule, regulation, interpretive release, interpretive letter, or "no-action" letter issued by the Commission that applies to the specific fact situation of the arrangement;
- the receipt by associated persons of such compensation is treated as compensation received by the member for purposes of the Rules of the Association; and
- the record keeping requirement in paragraph (g)(3) is satisfied.

No member or person associated with a member shall accept any compensation from an offeror which is in the form of securities of any kind.

Except for items as described in subparagraphs (g)(4)(A) and (B), a member shall maintain records of all compensation received by the member or its associated persons from offerors. The records shall include

the names of the offerors, the names of the associated persons, the amount of cash, the nature and, if known, the value of non-cash compensation received.

No member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided in this provision. Notwithstanding the provisions of paragraph (g)(1) of the Rule, the following non-cash compensation arrangements are permitted:

- Gifts that do not exceed an annual amount per person fixed periodically by the Association and are not preconditioned on achievement of a sales target.
- An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment which is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a sales target.
- Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:
    - the record keeping requirement in paragraph (g)(3) is satisfied;
    - associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not preconditioned by the member on the achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by paragraph (g)(4)(D);
    - the location is appropriate to the purpose of the meeting, which shall mean an office of the offeror or the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings;
    - the payment or reimbursement is not applied to the expenses of guests of the associated person; and
    - the payment or reimbursement by the offeror is not preconditioned by the offeror on the achievement of a sales target or any other non-cash compensation arrangement permitted by paragraph (g)(4)(D).
- Non-cash compensation arrangements between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an affiliated member, provided that:
    - the member's or non-member's non-cash compensation arrangement, if it includes variable contract securities, is based on the total production of associated persons with respect to all variable contract securities distributed by the member;
    - the non-cash compensation arrangement requires that the credit received for each variable contract security is equally weighted;
    - no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement; and
    - the record keeping requirement in paragraph (g)(3) is satisfied.
- Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, provided that the arrangement meets the criteria in subparagraph (g)(4)(D).

20.12 Twisting

The Term “Twisting” refers to the practice of misrepresenting a policy, misstating the facts, or giving an incomplete comparison of policies to induce the insured to give up a policy from one company and replace it with a policy from another.

To avoid the appearance of twisting, the following additional sales guidelines shall apply to the sale of variable products:

- RRs should have thorough knowledge of the features of a variable product prior to recommendation. Features include the death benefit, fees and expenses, subaccount choices, special features, withdrawal privileges, and tax treatment.
- Customers must be advised of the risks of variable life insurance including the risk of loss in the underlying investments which may result in a cash value of the policy that is either too low to maintain the value of the death benefit or will become too low if the policyholder doesn’t pay higher premiums.
- Disclosure documents available for variable life products must be provided to the customer at the time of recommendation. A record should be made of provision of the disclosure document (when and to whom provided).
- Variable annuities cannot be represented as short-term or liquid investments. References to liquidity must disclose the effect of liquidating *(e.g.,* tax consequences; surrender charges).
- Variable annuities are designed to be long-term investments for retirement. The customer should be aware that withdrawals prior to age 59 1/2; are subject to tax penalties and many variable annuities assess surrender charges for withdrawals within a specified time period after purchase.
- Be alert to the investment experience of customers purchasing variable contracts. Customers should be comfortable with the risks of the sub-accounts in which they invest.
- Variable annuities cannot be described as ‘‘mutual funds’’.
- Purchasers of variable annuities must receive a prospectus. The RR should provide a prospectus when a variable annuity is recommended. Many applications include a box to check to indicate a prospectus has been provided or whether the customer would like one to be sent.
- Discuss all relevant facts with the customer including liquidity issues; fees and charges; applicable taxes or penalties and surrender charges; and market risk. Fees and charges include surrender charges, mortality and expense risk charge, administrative fees, underlying fund expenses, and other fees and charges.
- It is inappropriate to recommend the purchase of a variable annuity in a tax-qualified account solely on the basis of the product’s tax deferral feature.
- Ensure applications are complete and information included is accurate. ►►

Implementation Strategy

The Firm’s registered representatives are prohibited from making misleading, derogatory, false or maliciously critical statements about the financial condition of an insurance company. This includes repeating market rumors or circulating news articles questioning a competitor's solvency. As such, the designated supervisor will periodically review a representative sample of relevant communications with customers for any misrepresentation or misstatements of the facts regarding insurance policies. Any such communications by representatives that are outside the prescribed guidelines to be perceived or otherwise construed as “twisting” will be immediately investigated and resolved so as to protect the insured.

20.13 1035 Exchanges

A Section 1035 Exchange refers to a tax-free method of exchanging an existing life insurance or annuity policy for a new policy with a different company. The exchange must meet the requirements of Section 1035 of the Internal Revenue Code for the transaction to be tax-free. A 1035 Exchange allows the contract owner to exchange outdated contracts for more current and efficient contracts, while preserving the original policy's tax basis and deferring recognition of gain for federal income tax purposes.

Reasons for Using a 1035 Exchange

- **To avoid current income taxation on the gain in the "old" contract**

  Generally, the surrender of an existing insurance contract is a taxable event since the contract owner must recognize any gain on the "old" contract as current income. However, under IRC Section 1035 when one insurance, endowment, or annuity contract is exchanged for another, the transfer will be nontaxable, provided certain requirements are met. The IRS has indicated through Private Letter Rulings that it will apply a strict interpretation to the rules. For a transaction to qualify as a 1035 Exchange, the "old" contract must actually be exchanged for a "new" contract. It is not sufficient for the policyholder to receive a check and apply the proceeds to the purchase of a new contract. The exchange must take place between the two insurance companies

- **To preserve the adjusted basis of the "old" policy**

  Preserving the adjusted basis is preferable in situations in which the "old" contract currently has a "loss" because its adjusted basis is more than its current cash value. The adjusted basis is essentially the total gross premiums paid less any dividends or partial surrenders received. This basis carryover is important when the owner has a high cost basis in the "old" contract. For example, Jane Smith has a Whole Life policy she purchased 15 years ago. She paid $1,000 annual premium for the last 15 years and has received $5,000 in policy dividends. The policy currently has $6,000 in cash value. Jane's cost basis is $10,000 (15 x $1,000 less $5,000 dividends.) If Jane did not exchange the "old" policy for the "new" one, but rather surrendered it and purchased the "new" policy with the $6,000 surrender value, she would only have a $6,000 basis in the "new" policy. If, however, she exchanges the "old" policy, she will preserve the $10,000 cost basis.

Requirements & Guidelines

The owner and insured, or annuitant, on the "new" contract must be the same as under the "old" contract. However, changes in ownership may occur after the exchange is completed. The contracts involved must be life insurance, endowment, or annuity contracts issued by a life insurance company. These are the types of exchanges which are permitted: from an "old" life insurance contract to a "new" life insurance contract; from an "old" life insurance contract to a "new" annuity; from an "old" endowment contract to a "new" annuity contract; and from an "old" annuity contract to a "new" annuity contract. (*Note*: An "old" Annuity contract cannot be exchanged for a "new" life insurance contract.)

Two or more "old" contracts can be exchanged for one "new" contract. No limit is imposed on the number of contracts that can be exchanged for one contract. However, all contracts exchanged must be on the same insured and have the same owner. The adjusted basis of the "new" contract is the total adjusted basis of all contracts exchanged. The death benefit for the "new" contract may be less than that of the exchanged contract, provided that all other requirements are met. Face amount decreases within the first seven years of an exchange may result in MEC status. When the face amount is reduced in the first seven years, the seven-pay test for MEC determination is recalculated based upon the lower face amount.

Under current tax law, contracts exchanged must relate to the same insured. Any addition or removal of insureds on the "new" contract violates a strict interpretation of the regulations. For example, you cannot exchange a single-life contract for a last-to-die contract or vice versa. Under certain circumstances you may exchange a contract with an outstanding loan for a "new" contract. This depends on the guidelines followed by the insurance company with whom the "new" contract is to be taken out. One possibility would be for the loan to be canceled at the time of the exchange. If there is a gain in the contract, cancellation of the loan on the "old" policy is considered a distribution and may be a taxable event. One way of avoiding this result would be to pay off the existing loan prior to the exchange.

Exchanging a deferred annuity for an immediate annuity qualifies for tax deferral under IRC Section 1035. However, avoidance of the 10% will depend upon which of the IRC Section 72 exceptions the client is relying upon:

- Payments made on or after the date on which the taxpayer becomes 59 1/2 will avoid the 10% penalty.
- Payments that are part of a series of substantially equal periodic payments made for the life expectancy of the taxpayer or the joint life expectancies of the owner and his or her beneficiary will also avoid the 10% penalty.
- Payments made under an immediate annuity contract for less than the life expectancy of a taxpayer who is under age 59 1/2 probably will not avoid the 10% penalty. IRC Section 72 requires that the immediate annuity payments begin within one year of the purchase. The IRS will most likely contend that the purchase date of the "new" contract will relate back to the date of the original purchase of the deferred annuity. Since it is unlikely the original annuity was purchased within one year of the "new" annuity’s starting date, the payments will probably not qualify for this exception.

Assignment to Insurer

The transfer of ownership in the old policy(ies) to the new insurer is effected with an irrevocable assignment by the owner to the insurer, with a designation of the insurer as both owner and beneficiary of the old contract. The parties to the exchange will then be: (1) the owner of the "old" contract; (2) the insurer of the "old" contract; and (3) the "new" insurer. The owner makes an absolute assignment of the "old" contract to the "new" insurer by notifying the "old" insurer, in writing. The "new" insurer then surrenders the old policy to the "old" insurer, and applies the proceeds of the surrender to a newly issued contract on the same insured.

The Notice of Assignment and Change of Beneficiary form, as well as the Notice of Intent to Surrender, should make reference to the owner’s intention to effectuate a 1035 Exchange. The policy assigned to the "new" insurer will ordinarily have a stated value. Therefore, the "new" insurer receives valuable consideration upon assignment to it of the "old" policy. For this reason, the "old" policy should not be assigned to the "new" company unless a favorable underwriting decision has been made and accepted by the policyholder (this is especially important for life insurance exchanges). ►►

Implementation Strategy

In the event the Firm engages in 1035 Exchanges, the designated principal will review each 1035 Exchange to ensure that the owner and insured, or annuitant, on the "new" contract must be the same as under the "old" contract. However, changes in ownership may occur after the exchange is completed. The contracts involved must be life insurance, endowment, or annuity contracts issued by a life insurance company. As such, the designated supervisor will review relevant documentation to ensure that only certain type of exchanges are permitted (e.g. an "old" life insurance contract to a "new" life insurance contract; from an "old" life insurance contract to a "new" annuity; from an "old" endowment contract to a "new"

annuity contract; and from an "old" annuity contract to a "new" annuity contract).

The transfer of ownership in the old policy(ies) to the new insurer is effected with an irrevocable assignment by the owner to the insurer, with a designation of the insurer as both owner and beneficiary of the old contract. Therefore, the designated supervisor will review to ensure that a Notice of Assignment and Change of Beneficiary form, as well as the Notice of Intent to Surrender are used in the exchange process, which should make reference to the owner's intention to effectuate a 1035 Exchange. The designated supervisor will initial and date all relevant documentation pertaining to 1035 Exchanges as evidence of review.

20.14 Equity-Indexed Annuities (EIAs)

Equity-indexed annuities are financial instruments in which the issuer, usually an insurance company, guarantees a stated interest rate and some protection from loss of principal, and provides an opportunity to earn additional interest based on the performance of a securities market index. Some EIAs are not registered under the Securities Act of 1933 based on a determination that they are insurance products that fall within that statute's Section 3(a)(8) exemption and therefore are not considered to be securities

Classification of Unregistered EIAs

Section 2(a)(1) of the Securities Act broadly defines "security" to include such financial instruments as evidence of indebtedness, participation in profit-sharing agreements, and investment contracts. Section 3(a)(8) generally exempts from the Securities Act any security that is an "insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia."

In 1986, the Commission adopted Rule 151, a "safe harbor" under the Securities Act, which clarifies when certain annuity contracts are exempted securities under Section 3(a)(8). The fundamental construct of Rule 151 is derived from prior judicial interpretations of Section 3(a)(8). Consequently, the Commission has stated that the rationale underlying the conditions set forth in the rule are, along with applicable judicial interpretations, relevant to any Section 3(a)(8) analysis.

In order for the Rule 151 safe harbor to apply:

- the product must be issued by an insurer that is subject to state insurance regulation;
- the insurer must assume investment risk, as provided in paragraph (b) of the rule; and
- the product may not be marketed primarily as an investment.

The status of any particular EIA under the safe harbor (or under Section 3(a)(8)) will depend on the facts and circumstances. Therefore, as a matter of internal policy, the Firm has developed specific procedures addressing the matter of EIAs (NTM 05-50; Aug. 8, 2005) ►►

Implementation Strategy

Effective July 1, 2007, the Firm requires that all sales of unregistered EIAs occur through the Firm, the designated supervisory principal is responsible for providing adequate supervision of EIA marketing materials, suitability analysis, and other sales practices associated with the recommendation of unregistered EIAs in the same manner that it supervises the sale of securities. The designated supervisor will also ensure that associated persons who engage in the offer or sale of EIAs through the Firm attend adequate training to understand EIA features and suitability issues for customers.

The designated supervisory principal of the Firm is responsible for maintaining a list of acceptable unregistered EIAs and prohibiting its associated persons from selling

any other unregistered EIA, unless the associated person notifies the Firm in writing of the intent to recommend an unregistered EIA that is not on the Firm's list, and receives the Firm's written confirmation that the sale of the unregistered EIA is acceptable.

20.15 Sales of Existing Life Insurance Policies to Third Parties ("Life Settlements")

The life settlement market emerged as an offshoot of the viatical settlement industry that developed in the 1980s as a source of liquidity for AIDS patients and other terminally ill policyholders with life expectancies of less than two years. Unlike viaticals, however, life settlements involve policyholders who are not terminally ill, but generally have a life expectancy of between two and ten years. Life settlements also tend to involve policies with higher net death benefits than viaticals.

Although business models vary, in a typical scenario, an insured sells an existing policy to a life settlement provider, which either holds it to maturity and collects the net death benefit, or sells the policy or interests in multiple, bundled policies to hedge funds or other investors. The insured may contact the life settlement provider directly, or through a financial adviser, or may use a life settlement broker, which solicits bids from multiple life settlement providers on behalf of the insured. In most states, both life settlement providers and life settlement brokers are subject to licensing and other requirements.

Obligations under FINRA Rules for Firms and Associated Persons When Recommending or Facilitating the Sale of an Existing Variable Life Insurance Policy to Third Parties

Suitability

Rule 2310 requires that, before recommending the purchase, sale or exchange of a security, members must have a reasonable basis for believing that the transaction is suitable for the customer. This analysis requires an associated person to fully understand and explain to their customers the products and transactions they recommend. This analysis also requires an associated person to make reasonable efforts to obtain information concerning the customer's financial status, tax status, investment objectives and other relevant information.

Associated persons must present a fair and balanced view of life settlements. A variable life settlement may be a valuable option for insureds who otherwise would surrender their policies or allow them to lapse. However, variable life settlements are not for everyone. There can be significant costs associated with such transactions, and FINRA cautions firms that a variable life settlement is not necessarily suitable for a customer simply because the settlement price offered exceeds the policy's surrender value. Other relevant factors may include the customer's continued need for coverage, and, if the customer plans to replace the existing policy with another policy, the availability, adequacy and cost of comparable coverage. Depending on the circumstances, including the customer's stated financial needs and investment objectives, firms also may need to consider the basic tax and other relevant implications of selling a variable policy.

Due Diligence

While some states require that life settlement providers and brokers have confidentiality policies in place to protect the identity and the medical records of the insured, others do not. Likewise, some life settlement brokers only solicit bids from providers with such policies; others do not. Before recommending a life settlement to a customer, firms and associated persons should understand the confidentiality policies of the providers or brokers with whom they are doing business. They should also understand and be able to explain to their customers any ongoing obligations the customer will incur. For example, some life settlement providers require that the insured provide notification of significant medical developments.

Firms that allow their associated persons to recommend variable life settlements may want to consider developing a list of approved life settlement providers and/or brokers whose policies and practices are consistent with the firms' obligations to its customers. At a minimum, firms should prohibit their associated persons from recommending variable life settlements that involve life settlement providers and brokers that are not properly licensed where such licenses are required.

Best Execution

Firms recommending that a customer sell a variable life insurance policy should make reasonable efforts to obtain bids from multiple licensed providers, either directly or through a life settlement broker. Therefore, an exclusivity arrangement between a firm or an associated person and one life settlement provider would generally be inconsistent with the firm's best execution obligations. Moreover, in a market that is evolving as rapidly as the life settlement market, firms should regularly review their best execution policies and procedures to ensure that they continue to satisfy Rule 2320.

Training and Supervision

Firms must ensure that their written supervisory procedures require that the appropriate reasonable-basis suitability analysis is completed before transactions are recommended; associated persons perform appropriate customer-specific suitability analysis; all promotional materials are accurate and balanced; and all FINRA and SEC rules are followed. In addition to establishing written procedures, firms also must document the steps they have taken to ensure adherence to these procedures.

Additionally, pursuant to Rule 3040, to the extent that an associated person participates in a settlement involving a variable life insurance policy outside the regular course or scope of the associated person's employment with a member, the associated person must provide prior written notice to the member describing the proposed transaction in detail. If the associated person is to receive compensation in connection with the transaction, the member firm must approve in writing the associated person's participation in the transaction, must record it on the firm's books and records and must supervise the person's participation as if the transaction were executed on behalf of the member.

Compensation in Connection with Variable Insurance Contracts

FINRA Rule 2320 (formally NASD Rule 2820), governing the sale and distribution of variable contracts, prohibits an associated person from accepting any compensation from anyone other than the member with which the person is associated except in the manner specified by the rule. Members therefore should ensure that any compensation received by associated persons in connection with recommendations to sell a variable life insurance policy comports with this rule.

Participation in the Subsequent Marketing and Sale of Interests in Life Settlements

FINRA is concerned about the involvement of FINRA members and associated persons in the subsequent marketing and sale of interests in life insurance policies for investment purposes. Depending on the circumstances, entities participating in the sale and marketing of interests in life insurance policies, variable or not, for investment purposes may trigger broker-dealer registration requirements under the Securities Exchange Act of 1934. (NTM 06-38; Aug. 9, 2006) ►►

Implementation Strategy

In the event the Firm engages in variable life settlements, the designated supervisor will ensure that each registered representative offering variable life settlements fully understand and explain to their customers the products and transactions they recommend. The supervisor is also reviewing relevant customer account documentation to ensure that each registered persons is making reasonable efforts to obtain information concerning the customer's financial status, tax status, investment objectives and other relevant information.

Before recommending a variable life settlement to a customer, the designated supervisor will periodically monitor registered persons to ensure that each representative understands the confidentiality policies of the providers or brokers with whom they are doing business. Additionally, the designated supervisor will prohibit associated persons from recommending variable life settlements that involve life settlement providers and brokers that are not properly licensed where such licenses are required.

In the event that an unregistered life settlement is treated or classified as an insurance product, the Firm will treat the sale or offering of such products as an outside business activity under Rule 3030 by associated persons in their capacity as insurance agents. Therefore, the Firm will require a prompt written disclosure describing the proposed activity and may subsequently choose to deny or limit the ability of associated persons to engage in the activity.

20.16 Deferred Variable Annuity Transactions (Rule 2821)

FINRA Rule 2330 (formerly NASD Rule 2821) addresses broker-dealer compliance and supervisory responsibilities for deferred variable annuities. FINRA Rule 2330 (formerly NASD Rule 2821) applies to the purchase or exchange (not sale or surrender) of a deferred variable annuity and the initial subaccount allocations. FINRA Rule 2330 (formerly NASD Rule 2821) does not apply to reallocations of subaccounts made or to funds paid after the initial purchase or exchange of a deferred variable annuity. FINRA Rule 2330 (formerly NASD Rule 2821) applies to the use of deferred variable annuities to fund IRAs, but not to deferred variable annuities sold to certain tax-qualified, employer-sponsored retirement or benefit plans, unless a member firm makes a recommendation to an individual plan participant, in which case the rule would apply to that recommendation.

Registered Representative Requirements for Recommended Transactions

Registered representatives must have a reasonable basis to believe that the customer has been informed of the material features of a deferred variable annuity, such as potential surrender period and surrender charge, potential tax penalty, mortality and expense fees, charges for and features of enhanced riders, insurance and investment components and market risk.

Registered representatives must also have a reasonable basis to believe that the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization or a death or living benefit.   A registered representative must have a reasonable basis to believe that each deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity, and riders and similar product enhancements, if any, are suitable. Therefore, the suitability determination must include careful consideration of the product in its entirety and its component parts, including initial subaccount allocations.

Exchanges

If an “exchange” of one variable annuity for another is involved, the registered representative must consider a number of additional factors to determine a reasonable basis for believing that the transaction as a whole also is suitable for the particular customer and. Those factors include whether (i) the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits, or be subject to increased fees or charges; (ii) the customer would benefit from product enhancements and improvements; and (iii) the customer’s account has had another deferred variable annuity exchange within the preceding thirty-six months.” Regarding the last factor, a registered representative must determine whether the customer has effected another exchange at the broker-dealer at which the representative is performing the review and must make reasonable efforts to ascertain whether the customer has effected an exchange at any other broker-dealer(s) within the preceding thirty-six months.

The rule also requires a registered representative to make reasonable efforts to ascertain and consider various other types of customer-specific information when recommending that a customer purchase or exchange a deferred variable annuity including the customer's age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, investment time horizon, existing assets (including investment and life insurance holdings), liquidity needs, liquid net worth, risk tolerance, tax status, and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers.

A registered representative who recommends the purchase or exchange of a deferred variable annuity must document and sign the determinations discussed above. This signed document must provide reviewing principals with enough information to adequately assess whether the registered representative has complied with the requirements of FINRA Rule 2330 (formerly NASD Rule 2821). (Ref. Regulatory Notice 07-53; Effective Date May 5, 2008) ►►

Implementation Strategy

Post effective date, the Firm's designated supervisor will ensure that before or at the time of a purchase or exchange of a deferred variable annuity, the Firm's registered representatives have reasonably determined suitability of each deferred variable annuity, evaluated the underlying subaccounts to which funds are allocated, and determined the appropriateness of riders and similar product enhancements. In determining suitability, registered representatives will consider certain customer-specific information including the customer's age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, investment time horizon, existing assets (including investment and life insurance holdings), liquidity needs, liquid net worth, risk tolerance, and tax status. Other elements may include product-specific considerations such as tax-deferred growth, annuitization or a death or living benefit. Each registered representative will complete the required transaction documentation which shall evidence determination of suitability and which shall be filed in each customer account file.

Principal Review and Approval Obligations for All Transactions

The rule requires review and approval prior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing, but no later than seven business days after an office of supervisory jurisdiction of the member receives a complete and correct application package, a registered principal shall review and determine whether he or she approves of the recommended purchase or exchange of the deferred variable annuity. (Ref. Notice 10-05; issued January 2010) .

> *Note: To alleviate the potential conflict between* FINRA Rule 2330 (formerly NASD Rule 2821) *and its review timing requirement and other FINRA rules, FINRA created an important exception: A broker-dealer may hold an application for a deferred variable annuity and a customer's non-negotiated check payable to an insurance company for up to seven (7) business days without violating either Rule 2330 or Rule 2820* formerly NASD Rule 2821) or FINRA Rule 2320 (formally NASD Rule 2820) *if the reason for the hold is to allow completion of principal review of the transaction pursuant to* FINRA Rule 2330 (formerly NASD Rule 2821). *The following conditions must be met: (1) the transaction is subject to the principal review requirements of* FINRA Rule 2330 (formerly NASD Rule 2821)*and a registered principal has reviewed and determined whether he or she approves of the purchase or exchange of the deferred variable annuity within seven business days; (2) the broker-dealer promptly transmits the check no later than noon of the business day following the date a registered principal reviews and determines whether he or she approves of the purchase or exchange of the deferred variable annuity; and (3) The broker-dealer maintains a copy of each such check and creates a record of the date the check was received from the customer and the date the check was transmitted to the insurance company if approved or returned to the customer if rejected.*

FINRA now clarifies that the interpretive relief applies only if the seven conditions delineated below are present.

1. The reason that the firm is holding the application for a deferred variable annuity and/or a customer's non-negotiated check payable to a third party is to allow completion of principal review of the transaction pursuant to FINRA Rule 2330.
2. The associated person who recommended the purchase or exchange of the deferred variable annuity makes reasonable efforts to safeguard the check and to promptly prepare and forward a complete and correct copy of the application package to an OSJ.
3. The firm has policies and procedures in place that are reasonably designed to ensure that the check is safeguarded and that reasonable efforts are made to promptly prepare and forward a complete and correct copy of the application package to an OSJ
4. A principal reviews and makes a determination of whether to approve or reject the purchase or exchange of the deferred variable annuity in accordance with the provisions of FINRA Rule 2330.
5. The firm holds the application and/or check no longer than seven business days from the date an OSJ receives a complete and correct copy of the application package.
6. The firm maintains a copy of each such check and creates a record of the date the check was received from the customer and the date the check was transmitted to the insurance company or returned to the customer.
7. The firm creates a record of the date when the OSJ receives a complete and correct copy of the application package.

If these seven conditions are not present, FINRA's interpretive relief will not apply and it will enforce FINRA Rules 2150(a) and 2320(d), as appropriate. (Ref. Notice 10-05; issued January 2010)

Additionally, a principal shall only approve the transaction if he or she determines that there is a reasonable basis to believe that the transaction is suitable. However, a principal who determines that a transaction is unsuitable nonetheless may authorize the processing of the transaction if the principal determines that the transaction was not recommended and that the customer, after being informed of the reason why the principal found it to be unsuitable, affirms that he or she wants to proceed with the purchase or exchange of the deferred variable annuity. All of the determinations required by this part of the rule must be documented and signed by the principal. FINRA emphasizes, however, that the rule does not *require* broker-dealers to effect trades that they determine are not suitable; rather, the rule *permits* them to do so under narrow circumstances. (Ref. Regulatory Notice 07-53; Effective Date May 5, 2008) ►►

Implementation Strategy

Post effective date, the Firm's designated supervisor and/or his or her designee(s) will review and approve each deferred variable annuity transaction prior to transmitting a customer's application to the issuing insurance company for processing, but no later than seven (7) business days after the Firm's OSJ receives a complete and correct application package.

Training Program

Firms must create training programs for registered representatives who sell, and for registered principals who review transactions in, deferred variable annuities. Among other factors, firms must include training on the material aspects of deferred variable annuities. (Ref. Regulatory Notice 07-53; Effective Date May 5, 2008) ►►

Implementation Strategy

Post effective date, the Firm's designated supervisor and/or his or her designee(s) will prepare a training program specific to deferred variable annuities. The Firm will include training on material aspects of deferred variable annuities in its Firm Element Continuing Education Program (CEP) each year to ensure that registered persons receive sufficient training on deferred variable annuity products.