TX Annuity CE-A

Chapter 1 Suitability of the Annuity Decision

An annuity is generally defined as a stream of regular payments. An annuity insurance policy is a contract in which the insurer promises the insured, called the annuitant, a regular series of payments, called rent. The basic insurance principles that underlie an annuity insurance operation are the same as those that underlie all insurance operations. That is, the insurance company combines many individuals exposed to the same peril. It uses the law of large numbers to predict in advance the payments it must make. Then it charges each insured a fair share of all losses. By charging a premium of all the individuals exposed to the peril, the insurance operation transfers money from all the people exposed to the peril to those who will experience the loss. The "loss" insured against with an annuity is living a long time. This sounds like a loss that most people would not dislike.

Function

Old age without money can be a tragedy. An annuity insurance operation transfers funds from those who die at a relatively early age to those who live to relatively old ages. That is, some annuitants will live to take out much more than they paid in as a premium. Other annuitants will not live long enough to take out as much as they paid in. Every annuitant pays a fair premium to enter the annuity insurance pool. In exchange for the premium, the annuitant obtains the right to receive regular payments from the insurance pool as long as he or she is alive. An insurance company earns interest on all the money in the pool.

The annuity is an old instrument whose origin dates back to ancient Rome. Contracts, known as *annua*, promised an individual a stream of payments for a fixed term or a lifetime in return for an up-front payment. The purchase price was expressed as a multiple N of the annual income. Single-premium life annuities became available in the Middle Ages. During the 1700s, governments in several nations, including England and the Netherlands, sold annuities in lieu of government bonds. In 1808 the British government launched its modern annuity finance program in which the government received capital in return for a promise of lifetime payouts to the annuitants. The modern annuities market, in which private insurance companies sell insurance contracts to individuals who wish to avoid the risk of outliving their resources, emerged in the 1700s, together with the development of probability and finance theories. The annuity provides unique longevity insurance, but instead of being a popular instrument for reducing uncertainty on earnings at advanced ages, the market is thin. Savers are reluctant to cede an important share or their entire savings in exchange for a policy and prefer alternatives with greater risks. Providers are encountering difficulties in annuity pricing given the expectancy of life is lengthening.

Guarantees

All deferred fixed annuities are required to provide a guarantee of a return of principal and are also required to guarantee a minimum rate of interest consistent with state laws -- so called "non-forfeiture statutes". All immediate fixed annuities have guarantees relating to the amount and number of payments, either for life or some specified period of time. Similarly, all deferred variable annuities provide annuity tables which guarantee that, at annuitization, a certain sum of money will purchase a specified series of payments of certain value for life or a period certain. Where life insurance can be viewed as insurance against a premature death, annuities can be viewed as insurance against the hardships that can befall a person who lives a longer then expected life. An annuity provides income to guard against the hardships that could result, such as running short of resources or becoming a burden on someone else in such situations.

In many states, annuities are not required to be included as an asset of a deceased estate for probate purposes. Many annuities guarantee a death benefit which ensures that beneficiaries will have at least the amount invested in the annuity less withdrawals, if the annuitant dies during the accumulation period. This feature is important to annuitants who are concerned about the adverse effect of temporary market swings on their beneficiaries. In some annuity contracts, this benefit is increased over time to lock in beneficial market effects or otherwise increase the value. Furthermore, because this death benefit may likely avoid the time consuming probate process, beneficiaries will have immediate access to these benefits upon death of the annuitant.

Annuity Choices

Annuitization is generally an irreversible decision. For complete annuitization to be optimal it is necessary that consumers have no bequest motive and that the annuities pay survivors a rate of return net of administrative costs, which is greater than the return on conventional assets of matching financial risk. Consumers have shown a growing tendency to select options more flexible than annuities. As more customized options have become available, many participants have chosen more than one income option, starting with one and following with another: they use temporary mechanisms that need not involve life contingencies and receive only the necessary minimum amount of distributions to avoid federal tax penalties. Here is a list of the possible reasons why individuals choose not to purchase annuities;
1) The existence of substitutes.
2) The bequest motive.
3) Unforeseen large expenditures (such as medical care and nursing).
4) The high cost of annuities due to adverse selection (“annuitants live longer”).
5) The underestimation of personal longevity, myopia or misunderstandings about the properties of annuities.

If future mortality improves relative to current expectations, life insurer liabilities decrease because death benefit payments will be later than expected. However, annuity writers have a loss relative to current expectations because they have to pay annuity benefits longer than expected. If the mortality deteriorates, the situation is reversed: life insurers have losses and annuity writers have gains. Because of economies of scope and as life annuities and life insurance are mutually natural hedges. A hedge is a position established in one market in an attempt to offset exposure to price fluctuations in some opposite position in another market with the goal of minimizing one's exposure to unwanted risk.

Natural hedging utilizes this interaction of life insurance and annuities to a change in mortality to hedge against unexpected changes in future benefit payments. This same logic can be applied on an individual basis; Retirees will want to maximize the return available from their retirement funds. It is unfortunate that some unscrupulous agents want to take advantage of the lack of sophistication of these people by offering chimerical returns on financial products they (and they alone) can offer. Examples can be found in Chapter 3.

Determinants of Senior Investment Decisions

With concepts ranging from simple time deposits to complex economic vehicles, financial institutions have designed investment products with varying degrees of risk to meet differing investor preferences. These products range from very simple time deposits to complex structures involving sophisticated financial strategies. Products can vary significantly in their degree of risk and potential returns vary similarly. Investors are able to pick a portfolio of investment choices with potential risk and returns to suit their own preferences. Thus, the question; how are investors preferences formed?

Investor Behavior

When purchasing financial products, investor behavior is formed by factors including;

- advice from mentors
- input from media and information sources
- reference to past investment experience

Investors who have experienced loss make new investment decisions bearing such in mind. Additionally, investors refer to financial news and other information sources as basis for their assessment of risk in products they are considering. All these factors affect investor perception of risk, and aversion of risk. Through the formation of their risk attitude, investors build their forecast of potential return on financial products. Products of lower potential profit are acceptable when the risk associated with those products is similarly low. Ordinarily, higher risk products are tolerable to investors when the premiums are more attractive. When the assessment of risk and potential returns is appropriately balanced in the investors view, a purchase will ensue.

Financial professionals try to understand how investors assess risk and how their attitudes to risk are informed by the relationship of risk and potential return. This way, financial institutions can develop and package their products according to investor needs. Unfortunately, investors are often snared by glitzy marketing and slick packaging of financial products. This can be exacerbated by a lack of information, over-optimistic assessment of returns and an underestimation of risk leading to a poor portfolio arrangement.

Annuity Decision-making and Seniors

For most members of society, working or short-term memory gets worse as an individual’s age progresses. As they get older people’s goals shift from seeking knowledge to deriving meaning from life and ensuring good feelings. Because of this, emotions become more important in processing information and seniors use more emotional cues to enhance memory rather than factual details. Seniors remember what is or was important to them – the value of the knowledge that could impact them rather than the minutiae (perhaps the reason seniors sometimes do not remember specific annuity surrender charges is because they have no intention of surrendering the annuity and so these charges are perceived as irrelevant and therefore forgotten). This theory indicates that the decision-making process does not necessarily become impaired as people age, but transforms into a process that intentionally becomes more driven by the emotional context of the decision rather than the simple facts. It is not “impaired” decision-making but rather “appropriate” decision-making based on the senior’s needs and goals.

Risk Perception and Estimation

Risk perception is the belief (whether rational or irrational) about the chance of occurrence of a risk or about the extent, magnitude, and timing of its effect(s). It is about uncertainty. Risk perception is determined from the questions investors ask, their familiarity with organizational and management systems etc. all of which are important factors. Risk perception and propensity to risk have a strong negative correlation.

The propensity to build up risk can further affect actual behavior, where risk refers to how far decision makers are prepared to extend their exposure to risk. People facing uncertainty and ambiguity in available information construct inferences and draw conclusions for them. In short, the risks people are prepared to take are related to their attention, and interpretation and memory processes. These faculties determine people’s attitude to risk and their behavior in risk related decisions.

Emotion and Risk Perceptions

While it is straightforward to explain how individual insurance products help address mortality risk, it is difficult to measure how people recognize it and make decisions to handle it. Risk perception is often driven by affective processes which may ultimately lead to suboptimal risk management. In this context, ‘affective’ refers to the experience of feeling or emotion, as opposed to reason or rationale.

Prospect theory is a theory that describes decisions between alternatives that involve risk, i.e. alternatives with uncertain outcomes, where the probabilities are known. The model is descriptive. That is, it tries to model real-life choices, rather than optimal decisions. A more orthodox approach for the treatment of decision making has been to rely on normative models of choice.
Decision theory in economics and mathematics is concerned with identifying the values, uncertainties and other issues relevant in a given decision, its rationality, and the resulting optimal decision.

Most of decision theory is normative or prescriptive. It is concerned with identifying the best decision to take, assuming an ideal decision maker who is fully informed, able to compute with perfect accuracy, and fully rational. In economic decision making, utility is a measure of relative satisfaction. Given this measure, one may speak meaningfully of increasing or decreasing utility, and thereby explain economic behavior in terms of attempts to increase one's utility. Utility is often modeled to be affected by consumption of various goods and services, possession of wealth and spending of leisure time. Expected utility theory is a commonly deployed economic decision model.

Research in the area of individual decision behavior and strategic decisions has indicated that seniors do not always behave according to the assumptions of utility theory. That is, they do not seek to know all possible outcomes, always assign accurate probabilities to the outcomes they recognize, or consistently select the best payoff from considered alternatives. It has been observed that seniors typically fail to follow the canons of decision theory and that the ways they think about risk do not fit into classical conceptions of risk associated with utility theory.[1]

Loss Aversion

Investors are risk-seekers when faced with the prospect of losses, but are risk-averse when faced with the prospects of enjoying gains; they are loss averse and care about their expected worst-case returns. In *Prospect Theory* (1979) the economics Nobel Prize laureate Daniel Kahneman describes decisions between alternatives with uncertain outcomes where the probabilities are known. In prospect theory, Kahneman identified loss aversion- people's tendency to strongly prefer avoiding losses to acquiring gains. In fact, studies suggest that losses are twice as powerful, psychologically, as gains.

In their perpetual pursuit to mirror the risk-free rate of return, some investment advisors factor prospect theory and loss aversion into their asset-allocation schemes. But loss aversion studies opposing symmetrical outcomes…such as either winning $100 or losing $100. It provides little insight with respect to investor’s fear of positive asymmetric return profiles.

A Wall Street Journal article accounts for this "mental laziness" that prevents investors and advisors from challenging their status quo approach to investing (and consequently, not embracing alternative asset classes and strategies). "In short, your own mind acts like a compulsive yes-man who echoes whatever you want to believe. Psychologists call this mental gremlin the confirmation bias...people are twice as likely to seek information that confirms what they already believe as they are to consider evidence that would challenge those beliefs." (*How to Ignore the Yes-Man in Your Head*, Jason Zwieg, WSJ 11/19/09).

Senior Investment Experience and Risk

‘Once burned twice shy,’ ‘*gato escaldado, del agua fría huye,’ ‘Einmal und nie wieder!,’ ‘Chat échaudé craint l'eau froide;*’ These proverbs all counsel caution after a bad experience. In the same vein, an investor’s experience is an important factor influencing behavior. The success or failure of past investor experience influences the tendencies of investors towards risk and risk perception, and further affects decision-making behavior. Risk and investment experience tend to indicate a positive correlation and

[1] *Financial Capability: A Behavioral Economics Perspective*, de Meza, Irlenbusch, Reyniers, 2008

past experience of successful investment increases investor tolerance of risk. Investors with more experience have relatively high risk tolerance and they construct portfolios of higher risk. Inversely, unsuccessful past experience leads to reduced tolerance to risk. Financial professionals know that past investment behavior affects future investment behavior.

Despite risk perception and the tendency of such to be transmitted and influence the decision making behavior, people continue to make investments in the face of uncertainty. This decision making under risk is reflected in the individual investor's portfolio construction. That is, risk perception affects return expectations and asset allocation behavior simultaneously. Therefore the expected utility theory based on a traditional finance perspective cannot explain the anomalous investment behavior of irrational people. As mentioned above, since this incongruity was noticed, Kahneman has proposed prospect theory as a reasoned theoretical explanation for this phenomenon.

Mortality remains a difficult concept for people to understand, one that many prefer not to contemplate. Consequently, consumers often pair life expectancies with retirement planning exercises. The problem is that using this benchmark exposes people budgeting for retirement to the risk of outliving their planning horizon. The quest for higher return leads to inappropriate risk, or the yearning for safe principal brings a low investment yield. To counter such determinism, consumers must learn that life expectancy is only an average; but it is not terribly helpful for planning retirement needs. Illustrations that make use of survival probabilities for each year of retirement can be much more instructive in demonstrating the likelihood of an individual surviving to specific ages, and married individuals should understand that the chance of at least one spouse in the couple surviving to older ages is much greater.

Senior Decision-Making Bias

Sometimes senior investors can be affected by cognitive bias and emotions in decision-making behaviors, while supposedly 'rational' investors are not. A comparison explaining the differences in decision-making between young and old could be made by looking at a recent computer with a current microprocessor chip and an earlier one with an 8086 processor. Both can solve problems, but the early processor can take in only so much data at a time and then it processes the data more slowly than the computer with the latest-generation of chip. If the old processor received too much data it often went into a data loop freeze and did not generate an optimal solution. It appears normal aging eventually downgrades a person's mental hardware, but still allows him or her to compute. The act of engaging in risky decision-making in uncertain circumstances cannot be considered "rational" and that this descriptor should best be replaced with the more appropriate "heuristic" in that such decisions are by rule of thumb (they are experience based). In addition overconfidence or optimism is an Achilles heel leading to investment losses. Not unlike gamblers, individuals with this failing often feel they possess an innate talent and in their optimism, over-rate their own assessment ability. Having overconfidence and optimism causes people to further overestimate their own knowledge, underestimate risk, and it even reduces risk recognition. Decision-making in such circumstances may be understood without cognitive bias. It is important to understand that there is anchoring bias in the decision-making process which arises due to factors such as overconfidence, loss aversion, status quo bias, mental accounting, framing and so on. Investors in the process of assessing risks and returns are influenced by this anchor effect.

That mental prowess declines as individuals get older is not something newly realized, and many theories have been advanced over the years to try to explain why it happens. Two thousand years ago Cicero said senility was due to laziness and argued that mental stimulation would keep one sharp. Individuals are known to rely on their personal past experience as a foundation and that is where excessive self-confidence in decision-making can originate. Such investors make inappropriate decisions with insufficient information due to this personal trait. There continues to be a great deal of research into how old age affects the decision-making powers. However, it is not the insurance professional's job to ask why or even if the decisions of senior citizen are negatively impacted by aging. The agent's task is instead to establish operational parameters and clarify things that can be done to help seniors arrive at better decisions regarding the purchase of an annuity. The objective is to assist financial professionals involved in the annuity industry do a better job in producing products, sales materials, disclosures, and agent training that puts seniors in the position to make the best possible decision when it comes to buying an annuity.

Chapter 2 Protecting Senior Investors

Data show that baby boomers today control more than $13 trillion in household investable assets, or over 50% of total U.S. household investment assets. Projections also show that nearly one in every six Americans will be 65 or older by the year 2020. This is a U.S. Census projection as of August 2008. (Available at http://www.census.gov/population/www/projections/files/nation/summary/np2008-t2.xls. At year end 2007, approximately 38 million people were 65 or older. By 2020, they will number almost 55 million people. Given the increasing number of investors who will need advice and guidance, financial services firms are actively developing new products and seeking to provide financial advice and services to investors as they prepare for and reach retirement. [2]

Senior Issues

In light of these demographics, policy makers view the protection of senior investors as a top priority. While securities regulators have long focused on the senior population and its particular vulnerability to fraud and abuse, beginning in 2006 securities regulators expanded collaborative efforts aimed at protecting seniors by providing educational programs targeted to senior investors, conducting focused examinations of financial services firms doing business with senior investors, and prosecuting numerous investment scams preying on senior investors. On July 17, 2006, the SEC held its first "Seniors Summit" to examine how regulators and others could better coordinate efforts to protect older Americans from investment fraud. Securities regulators have also provided information and guidance to financial services firms regarding senior investors.

These efforts are part of the shared mission to protect senior investors. As part of the ongoing effort, in February 2008, the SEC Staff, North American Securities Administrators Association (NASAA) and FINRA undertook a new initiative to identify and publish examples of practices that financial services firms have developed with respect to their interactions with senior investors. Securities professionals, financial services firms, and industry groups were invited to voluntarily share their practices.5

Senior Practices

A cross-section of firms and financial services industry groups and others chose to participate in this effort, including broker-dealer and investment advisory firms, larger firms and smaller firms, and firms with a variety of organizational structures. The reporting in this chapter summarizes practices used by financial services firms and securities professionals in serving senior investors in the following areas:

- Getting started: how firms are thinking of ways to remodel their supervisory and compliance structures to meet the changing needs of senior investors;

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[2] *Protecting Senior Investors: Compliance Supervisory and Other Practices*, SEC, FINRA 09/08 is the source of Chapter information.

- Communicating effectively with senior investors;
- Training and educating firm employees on senior-specific issues (such as how to identify signs of diminished capacity and elder abuse);
- Establishing an internal process for escalating issues and taking next steps;
- Encouraging investors of all ages to prepare for the future;
- Advertising and marketing to senior investors;
- Obtaining information at account opening;
- Ensuring the appropriateness of investments; and
- Conducting senior-focused supervision, surveillance and compliance reviews.

This information provides practical examples to insurance professionals that are seeking to strengthen their infrastructure to assist them in working with senior investors in an ethical, respectful and informed manner. This report does not create or modify existing regulatory obligations with respect to senior investors. It also does not catalog the full range of compliance practices applicable to senior investors. Rather, this report focuses on specific, concrete steps that firms are taking to identify and respond to issues that are common in working with senior investors. By sharing this information, it is hoped that financial services firms will continue to identify and implement additional practices to help ensure that the financial services industry continues to consider the particular needs of senior investors.

I. The Challenges

Any discussion about seniors raises the obvious question of who, exactly, is a "senior investor." Because investors of any age do not necessarily share the same characteristics, investment objectives, risk tolerances, or financial profiles, any definition of the term "senior investor" would be either under-inclusive or over-inclusive. Thus, the term "senior investor" does not define or reference a specific age, but rather the idiom is used to include investors who have retired or are nearing retirement.

An investor's age and life stage are critical components of an investor's profile and firms cannot meet their regulatory obligations without considering these factors. Generally, "life stage" refers to the key milestones in an investor's life, such as marriage, buying a home, saving for children's college education, preparing for retirement and retirement. Nonetheless, issues such as diminished mental capacity may be more prevalent among older investors and older investors may also be more frequent targets for financial abuse.

Common Practices

It is also important to note that not all firms are alike, and therefore practices that may make sense for one firm may not make sense for another. However, there are certain issues and challenges that many firms commonly encounter in working with senior investors. Some of those issues relate to meeting regulatory obligations, such as assessing the appropriateness of an investment for investors at different stages of life, or marketing retirement products to investors who are at or near retirement age. Other challenges, such as recognizing the signs of diminished capacity or financial abuse, are not unique to the financial services industry. Included in this report are examples of various steps that firms are taking to address these challenges because firms indicated that these issues are becoming increasingly common, and are of concern to the financial services industry. Ultimately, investors will benefit when financial services firms consider and address these challenges in a proactive way.

The following scenario, along with others provided throughout this report, illustrates some of the challenges that firms face when working with senior investors and demonstrates the importance of taking steps to implement a program to address these issues.

> Mr. Investor is a 76 year old widower. Bob Securities Professional has handled his investment portfolio for 25 years. His investment objective for the last 10 years has been to generate income. Recently, Mr. Investor told Bob Securities Professional that he wanted to generate higher returns from his account, and to change the beneficiaries on his IRA and Trust account from his children to his sister-in-law. Bob Securities Professional also began to notice that Mr. Investor didn't always return his telephone calls, which was unusual, as they spoke regularly over their 25 year relationship.
>
> Bob Securities Professional is concerned about altering the investment strategy to take on more risk and also about changing the beneficiary of Mr. Investor's account under these conditions. Bob Securities Professional wonders what, if anything, he should do next.

II. Practices Used by Financial Services Firms In Serving Seniors

During the collection of information for this report, many firms indicated that they have implemented and are implementing new processes and procedures aimed at addressing common issues associated with their interactions with senior investors. Some firms have indicated that they sought to consider a full range of issues, such as how to communicate effectively with senior investors; how to train and educate firm employees on senior-specific issues; how to establish an internal process for escalating issues and taking next steps when issues or questions are identified; how to encourage investors of all ages to prepare for the future; how to advertise and market to senior investors; obtaining information at account opening; how to ensure the appropriateness of investments; and how to conduct supervision, surveillance and compliance reviews focused on senior-specific issues.

A. Remodeling Supervisory and Compliance Structures to Meet Senior Needs

Some firms indicated that they have sought to develop a consistent process for addressing senior-related issues throughout the firm. To accomplish this goal, some firms created internal working groups, task forces, or committees, while others have designated one or more individuals within compliance, legal or management to focus on senior-related issues.

Address Senior Operations

The role of these groups or designated individuals varies greatly among firms, and examples of their responsibilities, some of which already are required, include:

- Conducting an inventory of the firm's operations and identifying areas of the firm that need to emphasize investors' life stage issues.
- Reviewing the adequacy of existing policies and procedures within different areas of the firm that need to incorporate investors' life stage issues.
- Reviewing products for appropriateness for senior investors.
- Establishing age-based restrictions on certain products or product features.
- Reviewing the use of proposed senior designations.
- Reviewing and approving marketing materials aimed at senior investors.
- Developing firm-wide escalation procedures to assist financial professionals in raising concerns about potential diminished capacity or elder financial abuse situations.
- Making in-depth training opportunities available for the firm, including training by experts on issues related to aging.
- Consolidating all senior investor-related information into one website for easy access for financial professionals.
- Reviewing, and modifying when necessary, criteria used for risk-based supervisory and compliance reviews.
- Providing input in connection with the firm's annual risk assessment regarding risks related to senior investors.

For many firms, this type of group or task force was viewed as helpful in streamlining processes across business units, acting as a central resource for issues related to seniors, and serving as a contact for employees as they come across situations they need help to resolve. In establishing and operating such groups, some firms:

- Include individuals from various areas of the firm and with different operational experience on the committee or taskforce, including but not limited to staff from portfolio management, sales, marketing, legal, compliance, and/or internal audit.
- Meet on a regular basis to discuss issues surrounding senior-specific policies and procedures.

For some firms, based on their size or other factors, establishing committees or working groups may not make sense. For these firms, designating a specific individual or a department to identify and develop protocols for working through senior-related issues or to serve as a central point of contact for questions about senior issues may be an alternative to establishing a committee or working group.

B. Communicating Effectively With Senior Investors

Financial services firms explained that they have adopted practices that they believe improve their communication with senior investors. These include:

- Increasing the frequency of contact with senior investors to remain informed about changes in investors' financial needs, employment status, health, and other life events.
- Encouraging financial professionals to talk to investors about having an emergency or alternate contact on file with the firm, such as a trusted family member or other trusted individual.
- Educating investors about the benefits of having a power of attorney and when appropriate, encouraging investors who are in good health to share details of their financial affairs with trusted family members, estate lawyers and/or other

professionals to help ensure that if the investor's health deteriorates, their financial affairs will be properly handled.
- Documenting conversations with investors in case they have problems with lack of recall or to help resolve any misunderstanding.
- Sending follow-up letters to investors after conversations to document and reiterate what was discussed.
- Avoiding financial jargon, using plain language, and having larger font versions of marketing materials available.
- Providing brochures that explain to investors how to identify, locate, organize and store important documents so that they are easily accessible in case of an emergency.

Media Targeting Seniors

Many firms produce brochures, newsletters and magazines aimed at educating senior investors. Some firms include educational materials in their monthly or quarterly mailings to investors. These materials are targeted to both a particular age group and life stage, and examples include:

- Marketing pieces (*i.e.*, booklets, magazines, and single page flyers) to assist investors in understanding specific products, meeting financial goals and investment strategies for pre-retirement and retirement.
- Publications that are education-oriented and cover topics such as analyzing social security and retirement benefits, identifying healthcare and estate planning resources.
- Educational materials created by third parties and educational resources from public websites targeted to senior investors.

It is noted that many of these materials may be primarily designed to market retirement-oriented services and products to senior investors. Firms must make sure that these materials, like all materials provided to investors, are not misleading and comply with relevant regulatory requirements.

C. Training Firm Employees On Senior-Specific Issues

Many firms have taken a proactive approach in training their financial professionals to help ensure that when they are faced with similar difficult and sensitive situations, they have the proper tools to address the issues raised. Firms utilize a variety of training methods to help ensure that the training is effective, including the following:

- Using hypothetical examples to illustrate the potential issues that financial professionals may encounter.
- Creating web-based modules focused on diminished capacity, suitability, communicating with senior investors, advertising, the use of professional designations and elder financial abuse.
- Distributing periodic newsletters or emails that contain articles or reminders about current policies and procedures related to senior investors.
- Collaborating with gerontologists and other aging experts to help financial professionals understand and meet the needs of senior investors.
- Creating educational materials on multi-generational and wealth transfer issues and the transition from planning for retirement to managing financial needs during retirement.

- Using small, interactive groups of financial professionals as forums to discuss senior issues in depth.

Regardless of the mechanism used, many firms appear to be developing training for their employees on senior-specific issues. Two areas that firms mentioned in particular are how to identify signs of diminished capacity and elder financial abuse. Each area is discussed below.

> In the subsequent months, Bob Financial Professional spoke with Mr. Investor at least twice a month. Mr. Investor seemed disoriented and did not recall transactions that he had previously authorized. Bob Financial Professional noted these observations in his file. Bob Financial Professional asked Mr. Investor whether he had all of his financial information in one place. Mr. Investor was not sure where his financial information was located. Bob Financial Professional encouraged Mr. Investor to invite his Daughter to their meetings.

Training on How to Identify Diminished Capacity

In the data collection process, some firms said that a critical aspect of their educational programs for employees is focused on identifying signs of diminished mental capacity in an investor. The ability to observe changes in investors' behavior places financial professionals in a unique and challenging position. Firms shared their concerns about steps they are taking when an investor shows signs of diminished capacity, about their responsibilities in these instances, and about their potential liability in instances where the financial professional does not address the issue.

It is to be noted that financial professionals cannot take advantage of investors in a manner that would violate an adviser's fiduciary duty to the investor or a financial broker's responsibility to follow just and equitable principles of trade. Firms have an obligation to supervise employees to prevent this behavior. In circumstances where the investor appears to lack capacity to understand an investment or to provide informed consent, firms may want to consider implementing procedures for financial professionals to follow, such as seeking advice from supervisors about contacting a trusted family member or the person designated in the investor's power of attorney.

Red Flags

Many firms have included segments in their educational programs to help financial professionals identify signs or "red flags" that may indicate that an investor may have diminished capacity or a reduced ability to handle financial decisions. Examples of signs include, but are not limited to, the following:

- The investor appears unable to process simple concepts.
- The investor appears to have memory loss.
- The investor appears to have difficulty speaking or communicating.
- The investor appears unable to appreciate the consequences of decisions.

- The investor makes decisions that are inconsistent with his or her current long-term goals or commitments.
- The investor's behavior is erratic.
- The investor refuses to follow appropriate investment advice; this may be of particular concern when the advice is consistent with previously-stated investment objectives.
- The investor appears to be concerned or confused about missing funds in his or her account, where reviews indicate there were no unauthorized money movements or no money movements at all.
- The investor is not aware of, or does not understand, recently completed financial transactions.
- The investor appears to be disoriented with surroundings or social setting.
- The investor appears uncharacteristically unkempt or forgetful.

Training on How to Identify Elder Financial Abuse

Elder abuse comes in a variety of forms. It can be physical or emotional and can be in the form of neglect, abandonment, or through financial exploitation. Elder financial abuse is generally referred to as the misuse of a person's money or belongings by a family member or a person in a position of trust.

Similar to detecting diminished capacity, firms indicated that financial professionals are on the front lines of seeing indications of possible financial abuse and, as a result, have included segments in their educational programs to help financial professionals identify signs, or "red flags," that may indicate that an investor may be subject to elder abuse. Examples of these signs include:

- The investor gives a power of attorney to someone that, to the investor's financial professional, appears inappropriate.
- Indications that the investor does not have control over or access to his/her money.
- The investor's mailing address has been changed to an unfamiliar and unexplained address.
- Inability of the financial professional to speak directly to the investor, despite attempts to do so.
- The investor appears to be suddenly isolated from friends and family.
- There is a sudden, unexplained or unusual change in the investor's transaction patterns.
- There are unexplained disbursements made in an investor's account that are outside of the norm.
- The sudden appearance of a new individual involved in the investor's financial affairs.

D. Establishing an Internal Process for Escalating Issues

Many firms indicated that the key to responding to signs of diminished capacity or financial abuse is to establish internal procedures that permit the financial professional to obtain advice from others within the firm on possible next steps to take. The following are examples of escalation procedures or next steps identified by some firms:

- Requiring a financial professional to document suspected diminished capacity or elder financial abuse, and escalate the issue immediately.
- Clearly designating the individual or groups to whom the financial professional is to escalate the matter, *e.g.*, a branch manager, a designated member of the legal or compliance department or a specially-created senior task force within the firm.
- Training employees to escalate early - at the first sign.
- Embedding escalation procedures in employee training and continuing education courses.

Next Steps

Firms also reported that they had created and adopted policies with respect to the next steps to take after an issue was identified and escalated. These policies include:

- Prohibiting the financial professional from making financial recommendations to the investor or investments in the account until the concern no longer exists.
- Communicating with the investor's designated emergency contact or the person provided with power of attorney for the investor.
- Conducting a review of the investor's account and identifying any transactions or patterns that could indicate a problem (*i.e.*, financial abuse by a financial professional or other individual).
- Maintaining frequent contact with the investor to assess any new developments.
- Having a manager or designated individual communicate with the investor along with the financial professional who has direct responsibility for the investor's account.
- Notifying the legal and compliance departments of further conversations with the investor, and involving them as appropriate.
- Consulting appropriate state statutes to determine next steps, which may include alerting appropriate authorities, including a government protective services organization, if elder abuse is suspected.
- Documenting any contact with the legal department in the investor's file.

Firms indicated that having effective escalation procedures and a process for considering and taking further steps to be critical in helping to ensure that they address issues of possible diminished capacity or financial abuse.

E. Encouraging Investors of All Ages to Prepare for the Future

Financial services firms observed that they are considering steps that help them and their investors prepare for the future. Investors of *any* age can take steps to plan for the event of mental or physical incapacity. As stated above, some firms are asking investors to provide them with emergency or alternate contacts for use in the event that the firm is unable to contact the investor or if the firm suspects diminished capacity or elder abuse. Some firms specify the permitted purposes for contacting this alternate person and receive permission to keep this information in the investor's files.

Another approach is for the financial professional to ask the investor whether he/she has provided a power of attorney granting authority over the investor's account to a trusted friend or family member under certain circumstances. These arrangements may more formally facilitate the management of an investor's account should certain circumstances occur. Practices in this area include:

- Encouraging financial professionals to have conversations about the benefits of executing powers of attorney with all investors as a matter of routine during the account opening process.
- Encouraging financial professionals to have a conversation with the investor prior to opening an account as to whether anyone else should be consulted with regard to the account.

Power of Attorney

A power of attorney is an instrument in writing by which one person, as principal, appoints another as his agent and confers upon same the authority to perform certain specified acts or kinds of acts on behalf of the principal. Firms were mindful that powers of attorney can be abused and have developed practices to address risks associated with abuse of a power of attorney. Practices identified in this area include:

- Having a process for identifying accounts of investors where a power of attorney is added or changed, followed by a change in activity compared with the investor's stated financial objective and profile. For example, firms looked for evidence of unusual checks written out of the account within a given time frame, and a concentration of checks to a single, third-party payee.
- Requiring that copies of all confirmations and account statements be sent to both the account holder and the power of attorney.
- Having a process to check the signature of the investor against other signed documents received in order to determine authenticity.

Whether by encouraging investors to provide alternate contact information or to execute a power of attorney, firms stated that encouraging all investors to be prepared for the future was an increasingly important issue.

F. Advertising and Marketing to Seniors

Many firms indicated that they have adopted one or more practices that were outlined in the public report issued in September 2007 by the SEC's Staff, NASAA and FINRA titled, "*Protecting Seniors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars.*" In that report, in Appendix B, "Effective Compliance and Supervisory Practices," it was noted that examples of compliance and supervisory practices that appeared to be effective in helping to ensure adequate supervisory oversight and compliance with the securities laws. While that Report did not create or modify existing regulatory obligations to senior investors, practices in that Report were provided in order to assist financial services firms in reviewing their practices in this area. While the complete list is not reiterated here, some of the practices that many firms have adopted include:

- Banning financial professionals from using marketing materials to target particular age groups, such as referring to an event as a "senior seminar" or a "senior meeting."
- Providing an online brochure with detailed instructions accessible to all employees describing the approval process required for seminars, investor appreciation events, continuing education seminars, outside speaking events, booths/exhibits, and business building/networking events.
- Providing a library of pre-approved materials that were reviewed and approved by supervisory and compliance personnel.

- Using a web-based training module for financial professionals to use as reference when they are creating materials for senior-oriented events.
- Performing a minimum number of unannounced compliance visits to seminars on a yearly basis.
- Instituting a “mystery shopper” program where a compliance professional attends seminars unannounced to verify that financial professionals are conducting seminars in accordance with firm policies and procedures.
- Firms stated that these are among the mechanisms that they are using to heighten their review and approval processes for the use of marketing and sales materials and sales seminars by their employees with respect to seniors.

> Mr. Investor met with Bob Financial Professional to discuss his portfolio. At the meeting, Mr. Investor showed Bob Financial Professional an advertisement that he had received from another financial professional. The advertisement indicated that Mr. Investor would receive a 50% return on his investment. The bottom of the advertisement included the designation “Senior Specialist.” The title confused Mr. Investor.

The Use of Senior Designations

Some professionals use titles that imply they are experts at helping seniors with financial issues. “Senior designation" means any degree, title, credential, certificate, certification, accreditation, or approval, that expresses or implies that a broker or agent possesses expertise, training, competence, honesty, or reliability with regard to advising seniors in particular on finance, insurance, or risk management (See ‘Senior’ Specialists and Advisors: What You Should Know About Professional Designations” at http://www.sec.gov/investor/pubs/senior-profdes.htm)

Regulators have identified the use of senior designations in advertising and marketing materials as a possible risk to investors because a designation may be used to imply expertise or credentials, which may be inaccurate or misleading. Many states are limiting the use of designations. For example, Massachusetts, Nebraska, New Hampshire, Virginia and Washington have restricted the use of senior designations.

Heightened Review

As a result of increased scrutiny by regulators, many firms have heightened their review and approval processes for the use of senior designations by their employees, and they monitor and limit their use. Some examples of these policies include:

- Reviewing the training materials used by entities or organizations that confer a designation to ensure that predatory sales techniques are not included as part of the training.
- Verifying the appropriate use of designations during field office inspections by reviewing financial professionals’ business cards.
- Maintaining a list of approved designations.
- Maintaining a list of prohibited designations.
- Banning the use of any designation that includes the word “Senior” to help ensure that investors are not confused.

- Permitting the use of designations only if accredited by a national accreditation organization.

Firms said that they are using these mechanisms to heighten their review and approval processes for the use of senior designations by their employees, and to monitor and limit their use.

G. Obtaining Information at Account Opening

Pursuant to a variety of laws, rules and regulations, financial services firms are required to obtain sufficient information about an investor to ensure that recommendations are appropriate for the investor, and that the investor's account is managed consistent with the investor's investment objectives. This information includes the investor's age, financial and tax status, and investment objectives. (Under, for example, NASD Rule 2310)

Documenting the Account

It is noted that some firms use the account opening process to ask questions that may broaden the conversation with investors. For example, some firms are:

- Documenting the response to lifestyle questions such as, "When do you plan to retire?" "How much money do you need to retire in the fashion you want?" "Do you have any other issues or expenses that we should contemplate as you retire?" "Do you have children or grandchildren who are dependent on you financially?" and "Do you have a will and a financial power of attorney?"
- Requiring in-person meetings with the investor to fill out the new account form. This helps to ensure that all investor information on the new account form is accurate and up-to-date.
- Encouraging the investor to bring a trusted family member or trusted individual to meetings.
- Requiring frequent updates of new account information, such as on an annual basis.

Firms remarked that these steps better help them to obtain information about investors at account opening to aid in determining whether particular investments are appropriate.

> Mr. Investor's Daughter opened an account with Betty Financial Professional over the phone. Daughter informed Betty Financial Professional that she was nearing retirement and wanted to preserve her nest egg. Betty Financial Professional asked Daughter to provide financial information and then filled in the remainder of the new account form herself. Under investment objectives, Betty Financial Professional put "speculative." Betty Financial Professional purchased speculative stocks in Daughter's account.

H. Ensuring the Appropriateness of Investments

Investors who are the same age can have very different investment profiles, and what is appropriate for one investor may not be appropriate for another investor. However, an investor’s age and life stage are important factors in assessing the appropriateness of recommendations for that investor.

Risk-Based Review

Some firms are using age in their risk-based supervisory reviews of investors’ accounts, as well as other information, to identify accounts or transactions for heightened review. These reviews may include the following:

- Assigning investment objectives to each product that the firm sells in order to aid financial professionals in assessing the appropriateness of the product for a particular investor, and to facilitate comparisons between the objective of the product and the investor’s stated investment objective by supervisors and compliance personnel.
- Conducting periodic supervisory interviews with financial professionals to discuss the portfolios of their senior investors.
- Conducting periodic calls with senior investors to confirm whether there have been changes that would impact the investor’s account information, such as financial changes or changes to their investment objectives.
- Confirming with the investor directly whether particular transactions were solicited or unsolicited.
- Using financial planning tools that help investors plan for retirement, and anticipate expenses, lifestyle changes, and goals during retirement. The tools provide guidance to financial professionals regarding investment choices that may help the investor reach their stated objectives.
- Using a filtering program based on age and investment objectives to assist financial professionals in selecting appropriate annuity products for investors.
- Requiring special supervisory review of all new account forms reporting investment objectives more aggressive than “income” for investors over a certain age.
- Conducting specialized reviews of new accounts that are opened as guardianship or conservatorship relationships for verification of proper documentation.

Product-Age Considerations

Some firms have also implemented product-specific practices or limitations in order to reduce the likelihood that a product will be recommended to an investor for whom it is inappropriate. Some firms have included age-restrictions in their product-specific practices, including:

- Limiting or prohibiting purchases of certain investment products, such as certain structured products, based on an investor’s life stage and risk profile.
- Prohibiting purchases of certain variable life insurance products by investors who are above a certain age.
- Imposing an age maximum on certain annuity riders that have actuarially little or no benefit to persons above that age.
- Requiring completion of additional or “targeted” suitability documentation before a transaction is processed.

Transaction Responsibility

Other firms have implemented heightened reviews of all variable annuity purchases. For senior investors, deferred annuities may pose special appropriateness concerns depending on the investor's liquidity needs and investment time horizon. Broker-dealer firms have specific responsibilities with respect to transactions in deferred variable annuities (See NASD Rule 2821).

To help address these issues, some firms are:

- Creating a central review and approval process for all variable annuity transactions with special focus on purchases with additional riders. These firms have a process, independent of the financial professional, which compares the attributes of the product to the needs of the investor.
- Training a dedicated team of annuity application reviewers to be aware of the special nuances of these products.
- Requiring a heightened review of annuity applications for investors over a certain age in a low tax bracket or with low liquid net worth.
- Requiring financial professionals to fill out an annuity worksheet with the investor's age, net worth, assets, and other factors. This information is used by the firm to assign a risk score to determine whether a more enhanced review is required.
- Requiring the investor to select an investment time horizon for a variable annuity purchase. This helps supervisors review the variable annuity subaccount allocations for consistency with the designated investment time horizon.
- Requiring financial professionals to complete an individual attestation that they made certain representations and disclosures to the investor in connection with the annuity transaction, including the accuracy of the investor's profile, time horizon and the reason for purchase.
- Implementing a hard block that prohibits variable annuity products to be sold to investors above a certain age based on the time horizon required for the instrument to accrue any benefit to the investor, and/or the length of the surrender period in light of the age group's typical investment time horizon and liquidity needs.

As described above, firms are using a variety of techniques to help ensure the appropriateness of investments for seniors.

Mr. Investor also maintains an account with Betty Financial Professional. Recently, Betty Financial Professional suggested that Mr. Investor re-evaluate his portfolio and shift his investments from income-orientated financial to growth stocks. She also suggested that Mr. Investor add more speculative investments, in order to generate higher returns. Mr. Investor had difficulty understanding the complex structure of some of the recommendations. Currently Mr. Investor's portfolio is diversified and holds bonds and other income-producing products.

III. Senior-Focused Supervision, Surveillance and Compliance Reviews

While firms conduct supervisory and surveillance review of the activity in investors' accounts regardless of the age of the investor, some firms said that they use age or other parameters in their exception reports and other supervisory review activities in order to pay special attention to seniors' accounts.

Senior Impact

These firms attempt to capture transactions and practices that may particularly impact seniors. Some examples of these practices include:

- Maintaining trade blotters that contain account information (such as age, net worth, investment objective) alongside the transactions for ease in supervisory review.
- Restricting high-risk trading for investors over a certain age unless pre-approved.
- Using exception reports to isolate activities and accounts for additional review, such as IRA distributions above the minimum required distribution, 1035 exchange transactions or investors over a certain age that list "speculative" as an investment objective. "1035 exchanges" are so named because IRS Code Section 1035(a)(3) provides that no gain or loss shall be recognized on the exchange of one annuity contract for another annuity contract.
- Requiring that all 1035 exchanges and 72T distribution requests be approved by a direct supervisor *and* a central review unit to verify that the exchange is "72T." Distributions are so named because IRS Regulation 72t permits early withdrawal from a retirement account without the usual tax penalty (IRS Code Section 72(t)(2)(A)(iv)).
- Blocking a transaction if the surrender charge is greater than a pre-determined amount

Exception Reports

Some firms use exception reports to identify and monitor portfolio allocations, commissions, and other issues in accounts. The thresholds used in some of these exception reports are designed to identify risks that are common to senior investors; however, the individual thresholds used differ among firms. Some practices include:

- Identifying accounts of investors over a certain age that generated commissions in speculative or complex investments
- Identifying accounts of investors over a certain age that generated a commission-to-asset ratio above a certain percentage over a preceding period
- Identifying accounts of investors over a certain age that have 'conservative' or 'income' stated as their investment objective, and also have a margin loan balance above a certain threshold, and/or have option trading losses above a certain threshold over the preceding several months
- Identifying accounts of investors over a certain age that have concentration and margin debit balances above a certain threshold
- Identifying accounts of investors who are over a certain age, or of any age, in which a change in trading activity has occurred and a power of attorney has recently been added or amended
- Identifying investors over a certain age with IRA rollover accounts to review activity relative to age, financial information, investment objectives, and risk tolerance.

Targeted Reports

In addition to performing supervision, surveillance and compliance reviews of investors' accounts, firms also generate targeted reports concerning the activities of their financial professionals to help spot potentially inappropriate or abusive activity relating to senior investors. For example, firms use surveillance reports that identify financial professionals that:

- Sell a threshold number of annuities to investors over a certain age during a specified period
- Sell a threshold number of annuities with the same rider
- Have a senior investor base that is above a certain threshold percentage of the total investor base
- Generate commissions above a threshold amount during a particular period from invertors over a certain age
- Have a certain percentage of their rolling 12-month fees generated by investors over a certain age.

Firms stated that these types of supervisory, surveillance and compliance reviews were helpful to identify potentially inappropriate or abusive transactions or practices with respect to senior investors. As critical as identifying the questionable transaction or activity is effective investigation and follow-up to ensure that the investor is receiving appropriate financial service from the financial professional and the firm.

> Mr. Investor, Jr. is 49 years old and plans to retire next year. Mr. Investor's investment objective is conservative and he holds bonds and blue chip stocks in his portfolio. Last month, a highly speculative investment was purchased in his account. The Branch Manager/Chief Compliance Officer noted this apparent discrepancy during his review of transactions and inquired further.

IV. Conclusion

Given the increasing number of Americans who will need advice and guidance as they near and reach retirement age, the issues described in this report could not be more important for financial services firms that provide services to senior investors. As noted at the outset of this report, the protection of senior investors is viewed as a top priority.

This report describes a myriad of practices used by financial services firms when working with senior investors. Many firms are implementing new processes and procedures aimed at addressing common issues associated with their interactions with senior investors, including with respect to: communicating effectively with senior investors; training and educating firm employees on senior-specific issues (such as how to identify signs of diminished capacity and elder abuse); establishing an internal process for escalating issues and taking next steps when issues or questions are identified; encouraging investors of all ages to prepare for the future; advertising and marketing to senior investors; obtaining information at account opening; ensuring the appropriateness of investments; and conducting supervision, surveillance and compliance reviews focused on senior-specific issues.

Chapter 3 Stories From the Front Line

In recent years, senior citizens have increasingly become targets of financial abuse and fraud. Approximately 5 million senior citizens become victims of financial abuse and fraud each year. This trend is related to the high amount of wealth held by older investors as nearly one-third of all U.S. investors are between 50 and 64 years of age. It is particularly devastating when older investors are defrauded because they are generally beyond or near the end of their earning years and as a result, have little or no ability to rebuild their retirement funds.

Products and Practices Commonly Used to Defraud Seniors

The Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and the North American Securities Administrators Association (NASAA), which represents state securities regulators, are seeing a number of investment products and sales practices recurring in schemes to defraud older investors. The following are examples of products and practices that have triggered SEC, FINRA, and/or state securities regulator investigations in recent months. Investors should exercise caution before investing in these types of products.[3]

Charitable Gift Annuities

When investing in charitable annuities, investors should ensure that the firm or individual is representing a legitimate charitable organization and that the organization is fully aware of the salesperson's activities. In an increasing number of cases, a solicitor will pose as an employee of a charitable organization and offer customers the opportunity to invest money that will purportedly provide monthly annuity payments to both the investor and the charity. Unbeknownst to the investor, a significant portion of the funds are never invested for charitable purposes, but instead are directly deposited in the solicitor's personal account. The following are examples of such schemes that have triggered SEC and state securities regulator investigations.

Example

• The SEC sued Robert Dillie for defrauding senior investors of at least $52.9 million through the sale of charitable gift annuities. He represented to investors that their funds would go into stocks, bonds and money market accounts, but $19.2 million of the monies raised were diverted to a hidden account that afforded him a luxurious lifestyle. When the plan collapsed, he told investors that the company had "disbanded due to

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[3] The information in this chapter is derived from *Investor Alert, Investment Products and Sales Practices Commonly Used to Defraud Seniors: Stories from the Front Line;* SEC, FINRA, NASAA.

inadequate assets." [*See Securities and Exchange Commission v. Robert R. Dillie et al.* (Civil Action No. CV-01-2493-PHX-JAT)].

• Arizona state securities regulators obtained a $4.3 million final judgment against two insurance agents who fraudulently sold charitable gift annuities to seniors, telling them that their money would be invested in secure accounts. Instead the funds were placed in high-risk, speculative investments with the potential for a complete loss of those funds, and the insurance agents helped themselves to $1.3 million in commissions. *[See Arizona Corporation Commission v. One Vision Children's Foundation, Inc.,et al.* (State of Arizona, Maricopa County Superior Court, No. CV2002-020878)].

"High Return" or "Risk-Free" Investments

Investors should be wary of opportunities that promise spectacular profits or "guaranteed" returns. As the adage goes, if the deal sounds too good to be true, then it probably is. Commonly, an individual will claim that unrealistic returns can be realized from "Low-Risk Investment Opportunities." But no investment is risk-free. And sometimes the investment products touted do not even exist – they're merely scams. The following are examples of such schemes that have triggered SEC and state securities regulator investigations.

Example

• The SEC obtained a $112 million judgment against investment advisers who induced at least 803 seniors to invest in notes that purportedly paid a "guaranteed" return of 5.5% to 8% per year. The fraudsters claimed that investor funds would be used to make secured loans to businesses and that investors would be repaid their principal at maturity, but these representations were false. [*See SEC v. D.W. Heath & Associates, Inc., et al.,* No. CV 04-02949JFW (Ex) (C.D. Cal.)].

• Florida regulators sued two insurance agents who convinced clients to liquidate annuity investments and invest in a bogus real estate company by promising returns of up to 9%. Thomas A. Masciarelli and Steven Petrarca were convicted of aggravated white collar crime and making fraudulent investment transactions following an investigation by the Florida Department of Financial Services, Division of Insurance Fraud, and the Office of Financial Regulation. Detectives arrested Masciarelli a second time in 2005 and charged him with stealing $300,000 from three investors – a 58-year-old woman supporting a disabled adult daughter, an 82-year-old woman with no family, and an 80-year-old man suffering from Parkinson's disease. All three cases were nearly identical: Masciarelli sold them fixed annuities and then later advised them to cash out the annuities and buy investments purportedly offered through his own company. However, detectives said Masciarelli did not invest the funds but instead used the money for personal and other expenses. [*See* http://myfloridacfo.com/pressoffice/ViewMediaRelease.asp?ID=2354].

• Florida regulators sued three individuals who conspired to obtain money from investors by fraudulently representing that the viatical contracts they were selling were risk-free. Many of the victims were senior citizens who had invested their life savings in these policies.
[*See* http://myfloridacfo.com/pressoffice/ViewMediaRelease.asp?ID=2042].

Investment Adviser Services

An "investment adviser" is an individual or firm responsible for making investments on behalf of, and providing advice to, investors. An investment adviser has a duty to act in the best interest of their clients. Sometimes, however, investment advisers will take advantage of their positions of trust and use unauthorized and deceptive methods to misappropriate money directly from their clients. Investors should be careful to review their monthly account statements and to conduct annual reviews of their investment plans with their investment adviser. Investors should be vigilant for abnormal changes in their monthly account statements. The following are examples of investment adviser services that have triggered SEC and state securities regulator investigations.

Example

• Wisconsin state securities regulators issued an order of prohibition against a Duane C. Boechler, a former investment adviser who took over $7 million from at least 27 senior investors. The investors were mostly clients from his investment advisory business. The investors were told that their investments, either promissory notes or limited liability company interests in various businesses that Boechler had formed, were going to be used to improve these allegedly successful businesses. Instead the money was used to finance Boechler's lifestyle including his luxury apartment in Panama City and to repay earlier investors. Boechler is now also facing criminal charges in two Wisconsin counties. *See In the Matter of Duane C. Boechler,* File No. S-07034 (April 13, 2007)

• The SEC brought an action against an investment adviser who misappropriated over $5.4 million from the accounts of four profit-sharing plans that were owned by clients of her employer. As part of the scheme, the investment adviser placed unauthorized orders to sell securities in these accounts and forged documents that transferred the proceeds from those sales to the accounts of two elderly women who were also advisory clients. The adviser then forged the signatures of these women on checks that she made payable to herself, her creditors, and her relatives. [*See SEC v. Susana P. Longo,* Case No. 1:05-CV-0164 (N.D. Ga.)].

• The Oregon Department of Consumer and Business Services and the SEC charged an investment adviser with misleading investors and misappropriating their funds. The adviser raised millions of dollars from investors, including many seniors, by representing that he would invest their money in stocks and bonds. Instead, the adviser used the money to buy himself vintage cars and sports memorabilia. [*See SEC v. C. Wesley Rhodes, Jr., et al.,* Civil Action No. CV06-1353-MO (D. Or.); *In the Matter of Rhodes Econometrics, Inc. and Charles Wesley Rhodes Jr.* No. S-06-0036 (A)].

Certificates of Deposit or Bonds

Investors searching for relatively low-risk investments that can easily be converted into cash often turn to certificates of deposit (CDs). A CD is a special type of deposit account with a bank or thrift institution that typically offers a higher rate of interest than a regular savings account. Unlike other investments, CDs feature federal deposit insurance. Investors should be skeptical of promises of above-market returns and be careful to confirm the legitimacy of the CD with the named issuing bank or thrift institution. The following are examples of CD sales that have triggered SEC and state securities regulator investigations.

Examples

• The SEC filed a complaint against individuals who raised more than $3.9 million from at least 50 investors by selling CDs that did not exist. The fraudsters lured investors, many of whom were seniors, with promises of above market rates on FDIC-insured CDs purportedly issued by an entity called the "Liberty Certificate of Deposit Trust Fund." Rather than purchasing the CDs as agreed, the perpetrators used the invested money to make payments to prior investors and for their own personal uses. [*See SEC v. Reinhard et al.,* Civil Action No. 06-997-CMR (E.D. Pa.)].

• The SEC and the Florida Office of Financial Regulation filed an Emergency action and secured injunctions and asset freezes against financial services firm AmeriFirst Funding and its principals for defrauding investors of approximately $55 million in a fraudulent offer and sale of so-called Secured Debt Obligations (SDOs). AmeriFirst sales agents lured older investors and those saving for retirement, with advertisements for relatively high-yielding FDIC-insured certificates of deposit, then convinced the investors to purchase the SDOs instead. Defendants falsely asserted that the investment had little or no risk because accounts were guaranteed by a commercial bank, protected by many layers of insurance coverage and fully secured by collateral. [*See SEC v. Amerifirst Funding, Inc., et al.* Civil Action No. 3:07-CV-1188-D (N.D. Tex.); *State of Florida vs. AmeriFirst Funding Inc. et al.*].

Promissory Notes

A promissory note is a form of debt – similar to a loan– that a company may issue to raise money. Typically, an investor agrees to loan money to a company for a set period of time. In exchange, the company promises to pay the investor a fixed return on his or her investment, generally principal plus annual interest. While promissory notes can be legitimate investments, those that are marketed broadly to individual investors often turn out to be scams. Investors should carefully investigate the legitimacy of all promissory notes. The following are examples of such schemes that have triggered SEC and state securities regulator investigations.

Examples

• The SEC sued a number of individuals who used mailing lists to target seniors for investments in "guaranteed" and fully-collateralized promissory notes. The individuals distributed literature stating that the lengthy, complicated, and expensive Texas probate process could be overcome by employing their company’s planning services. Investors were urged to liquidate their legitimate, safe investments; to withdraw funds from their IRAs; and to invest in high-risk investments. Investors were told their investments would be used to fund business ventures, none of which existed. Instead, investor funds were misappropriated to inappropriate uses as the construction of a lake home and the payment of personal credit card debts. [*See SEC v. Gary Landon Davenport, et al.,* Case No. 7:99-CV-185-R (N.D. Tex.)].

• Georgia securities regulators brought charges against four individuals who had purportedly sold phony promissory notes to senior investors. The investors lost approximately $305,000. The investors had been told the investments were safe, guaranteed, and would earn a 2 to 3 % return each month.
[*See* http://sos.georgia.gov/pressrel/021006.htm].

Sale and Leaseback Contracts

In an attempt to avoid the investor protections of securities laws, some investments are structured to resemble the sale of a piece of equipment such as a payphone, ATM machine or Internet booth. Commonly, the equipment is located in a location where the investor cannot service or maintain the equipment and must enter into a servicing agreement. To make the deal more attractive, investors are told that after a given period the equipment can be sold back to the seller at the investor's original purchase price. The investor is also promised a specific rate of return. In a variant of this scheme, a real estate interest such as a long-term lease in a resort community is sold instead of physical equipment. Frequently the equipment or property does not exist, and the seller lacks the financial capacity to keep the promise of repurchase. Investors should be skeptical of such leaseback contracts.

Examples

The following are examples of sale and leaseback contracts that have triggered SEC and state securities regulator investigations in recent months.
• The SEC obtained a judgment against individuals who offered and sold unregistered investment contracts in a scheme involving pay telephone lease-backs. The scheme raised more than $74 million from more than 2,000 investors most of whom were seniors. [*See SEC v. Phoenix Telecom, L.L.C., et al.,* Civil Action File No. 1:00-CV-1970-JTC (N.D. Ga.)].

• In Texas, state securities regulators sued an individual who had deceived a senior into investing in a timeshare sale and leaseback arrangement involving hotels located in Branson, Missouri. In addition to a prison term, the individual was ordered to pay restitution of $35,000 to the investor. [*See* http://www.ssb.state.tx.us/Enforcement/2006_Civil_and_Criminal_Actions.php].

Unsuitable Investment Recommendations

Some unscrupulous investment advisers convince clients to purchase investment products that don't meet the objectives of an investor. Unsuitable recommendations can occur when a broker sells speculative investments such as options, futures, or penny stocks to a senior with a low risk tolerance. Investors should be careful to review the risk profile of each investment recommendation. The following are examples of actions that have triggered SEC, FINRA, and state securities regulator investigations.

Examples

• In Texas, three individuals were convicted of violations of the registration requirements of the Texas Securities Act in connection with a scheme that offered investments in high-risk foreign currency markets to senior citizens. [*See* http://www.ssb.state.tx.us/Enforcement/2006_Civil_and_Criminal_Actions.php].

• The SEC brought an enforcement action against two brokers who induced their clients to invest in unsuitably high-risk securities. To persuade seniors to invest large amounts of their savings and retirement funds in the high-risk securities, the brokers falsely represented that the investments had little or no risk and were as safe as bank deposits. [*See SEC v. William Edward Sears and Patricia Jean Sears Million,* Case No. CV-05-1473 CO (D. Ore.)].

• The Oregon Department of Consumer and Business Services revoked the securities license of a stockbroker and fined him $100,000 after finding that, instead of recommending investments appropriate for seniors, the stockbroker advised more than a dozen of his clients to become "general partners" in risky oil and gas ventures. In one instance, the stockbroker accompanied an 89-year-old man suffering from dementia to a bank branch, and instructed the visibly confused client to withdraw funds for investment purposes. [*See In the Matter of Jack Kleck*, Oregon Department of Consumer and Business Services No. S-07-0001].

• FINRA sanctioned a financial services firm for abusive sales practices and inadequate supervisory procedures because the company recommended inappropriately high-risk investments to its clients, a number of whom were retired or approaching retirement. The company was censured, fined $500,000, and ordered to make restitution totaling more than $2.8 million.
[*See* http://www.nasd.com/PressRoom/NewsReleases/2003NewsReleases/NASDW_002809]

• FINRA expelled a brokerage firm from its membership after it engaged in fraudulent and illegal sales activities. The firm used misleading and incomplete information to induce seniors into making highly risky private investments, leading to losses of over $10 million. [*See* http:www.nasd.com/PressRoom/ NewsReleases/2004NewsReleases /NASDW_010886].

• FINRA barred Travis Wakeley, a registered representative, from association with any FINRA member firm in any capacity after he made an investment recommendation to a senior that was not suitable for the customer based on her age, risk tolerance, investment objective, investment experience and net worth. [*See* FINRA Case #2005001267501].

• The New York Stock Exchange (NYSE) took action against a registered representative who engaged in a pattern of unsuitable trading in the accounts of nine customers, seven of whom were seniors. Over a three-year period, the customers saw a total realized loss of approximately $1,321,988 and the registered representative earned approximately $585,274 in commissions from these accounts. [*See Kenneth Edward Stephens*, Decision 06-216 NYSE Hearing Board (December 13, 2006)].

Churning

"Churning" refers to; financial professionals making unnecessary and excessive trades in customer accounts for the sole purpose of generating commissions or the inappropriate exchange of a life or annuity product. Most churning occurs where a broker has discretion to trade the account without prior approval from the client.

Investors should be careful to review their monthly account statements and investigate any abnormally high trading activity. The following are examples of churning activities that have triggered FINRA and state securities regulator investigations.

Examples

• In Massachusetts, Secretary of the Commonwealth William F. Galvin fined a brokerage $1 million for the theft, churning, and unauthorized trading perpetrated by one of its agents. In addition to the $987,500 that it had already been ordered to pay to settle the senior investor's claim, the brokerage was ordered to pay $135,000 in restitution. [*See In the Matter of Oppenheimer & Co., Inc., & Stephen J. Toussaint*].

• FINRA sanctioned a broker who churned the accounts of two senior citizens. A default decision was entered against the broker, and he was barred from trading and ordered to pay $278,072.59 in restitution.
[*See* FINRA Case #ELI200400810].

• The Attorney General of New York reached a settlement agreement with a brokerage after it failed to supervise one of its brokers who defrauded 15 customers, many of whom were seniors, out of over $740,000. The broker mismanaged customer accounts by engaging in excessive, unauthorized, and unsuitable trading, signing wire transfers and new account documents without customer authorization, and failing to inform her clients of the risks of trading on margin. [*See* http://www.oag.state.ny.us/press/2006/oct/oct17a_06.html].

Equity Indexed Certificates of Deposit

Equity indexed CDs are hybrid securities products that offer an interest coupon payment that is based on a stock market index. Returns are not FDIC insured and are dependent on the performance of the stock market. As a result, these products may not be suitable for seniors who need liquid funds for retirement living.

High Pressure Sales Seminars

Investment advisers commonly invite investors to attend sales seminars. These seminars are sometimes held at upscale hotels and restaurants and offer a free meal. At these seminars, advisers often use high pressure sales tactics to pitch unsuitable products. Investors should avoid making rushed decisions at sales seminars and should seek objective third party advice before committing their funds. The following are examples of high pressure sales seminars that have triggered SEC and state securities regulator investigations.

Examples

• The SEC filed a complaint against an investment adviser who fraudulently solicited over $22 million from investors. The adviser invited investors to free dinner seminars for the sake of retirement planning and told the investors that he would invest their funds in real estate transactions that would provide returns as high as 24%. The adviser failed to purchase real estate, misrepresented to investors that their investments would be secured by real property, and failed to disclose that he used new investor money to pay returns to prior investors. [*See SEC v. Jon W. James*, No. 06 Civ. 4966 (C.D. Cal. Aug. 24, 2006)].

• The Nevada Securities Division filed a complaint against an individual who defrauded over 42 investors out of $2.7 million. The individual held seminars at several Las Vegas hotels and casinos, soliciting seniors to participate in various investment opportunities. Instead of investing the money as promised, the individual funneled investor funds into her personal accounts. She was charged with 23 felony violations for, amongst other things, the sale of unregistered securities and securities fraud. [*See* http://sos.state.nv.us/information/news/ press/2007/20070525.asp].

• A brokerage firm consented to an order entered by the Utah Division of Securities to pay a $50,000 fine after two of its agents were found offering free lunch seminars to seniors and misrepresenting the credentials of one of the agents. At the seminars, inaccurate and misleading information was presented in an attempt to persuade the seniors to transfer their investment accounts to one of the agents. [*See In the Matter of Andrew J. Moleff, John F. Hoschouer and World Group Securities, Inc.*].

• The Colorado Securities Commission sued an individual who fraudulently solicited over $600,000 from at least 25 investors who were induced into investing during free lunch seminars held at their retirement and senior centers. The perpetrator failed to invest the funds he raised and, instead, used the funds to pay his personal living expenses. [*See* http://co.jefferson.co.us/news/ news_item_T3_R354.htm].

Prime Bank Schemes

Investors should be particularly wary of investment opportunities that promise spectacular profits when the investment product is from outside of the U.S. securities markets. In prime bank schemes, individuals persuade investors to purchase and trade "prime bank" financial instruments on clandestine overseas markets. Neither these instruments, nor the markets on which they are allegedly traded exist. To provide the appearance of legitimacy, documents are distributed which appear to be, complex, sophisticated, and official. Investors are commonly told that they have special access to programs that otherwise would be reserved for top financiers on Wall Street. Investors are also told that profits of 100% or more are possible with little risk. The following is an example of a prime bank scheme that triggered an SEC investigation:

Examples

• The SEC sued several individuals involved in a massive nationwide prime bank scheme which targeted, amongst others, seniors. The perpetrators raised $45 million from 300 investors by selling “prime bank” securities. The perpetrators told investors that their funds would be deposited in a London bank, secured by a bank guarantee, and used as collateral to trade financial instruments with “top 50” European banks for annual returns of 24% to 60%. The prime bank program did not exist, no funds were sent to Europe, and the funds were left unsecured by any sort of guarantee. The investment funds had been misappropriated for personal and other unauthorized uses. [*See SEC v. Benjamin Franklin Cook*, No. 99 Civ. 571 (N.D. Tex. Mar. 17, 1999); *SEC* *v. Resource Development International, LLC*, No. 97 Civ. 1018Y, (N.D. Tex. filed Mar. 2002); *United States v. William Whelan*, No. 05 Crim. 00226OWW (E.D. Ca. Nov. 28, 2005)].

Pump and Dump Schemes

In a "pump and dump" scheme, individuals drive up the price of a company's stock (typically a microcap or penny stock) by issuing false and misleading statements. After the price is driven up, the individuals sell their own shares. Typically, at whatever point the individuals stop touting the stock, the price plummets and leaves legitimate investors with worthless or significantly devalued stock. Investors should remain particularly skeptical of any security that is priced below $5 or that does not trade on a registered securities exchange. Investors also should be suspicious of all "too good to be true" stories coming from salespersons who are neither registered brokers nor investment advisers. The following are examples of pump and dump schemes that have triggered SEC and FINRA investigations.

Examples

• The SEC sued a number of individuals who used telemarketers that employed high-pressure sales tactics and made false representations to investors in order to sell shares of a certain penny stock. As a result of the fraud, investors, many of whom were seniors, lost over $6.8 million. [*See SEC v. U.S. Gas & Elec., Inc., et al.* (S.D. FL 2006)].

• FINRA brought a successful disciplinary action against brokers in Brooklyn who used high-pressure sales tactics, fraudulent misrepresentations, baseless price predictions, and omissions of material facts to persuade investors – many of whom were seniors – to purchase shares of three highly speculative securities. The brokers were ordered to pay 10 customers more than $3.8 million in restitution, plus interest and costs. [*See* http://www.finra.org/PressRoom/News Releases/2005NewsReleases/P012997].

• FINRA sanctioned two investment firms for using fraudulent tactics to sell highly speculative securities to seniors and other investors. The firms manipulated the market and the price of stocks by permitting a broker to buy and sell shares in his personal accounts in order to give the appearance of market interest in the stock. [*See* http://www.nasd.com/PressRoom/NewsReleases/2004NewsReleases/ NASDW_002833].

Variable Annuities

Variable annuities are insurance products that allow investors to enjoy tax-deferred growth in mutual funds, while retaining the security of an insurance policy. While these products are legitimate investments, commissions for those who sell variable annuities are very high, and create incentives for sellers to promote products that are inappropriate for older investors. Variable annuities are generally not appropriate for most seniors or individuals near retirement because of their steep penalties incurred for early withdrawals. Investors should be skeptical of any broker who suggests purchasing a variable annuity to hold in a 401(k) or IRA because these accounts already provide tax-deferred growth, and the variable annuity simply adds a layer of cost with no additional tax benefits. The following are examples of actions that have triggered investigations.

Examples

• The Missouri State Commissioner of Securities sanctioned an investment adviser for recommending inappropriate variable annuity products to seniors. Eight Missouri residents between the ages of 72 and 87 invested approximately $1.2 million with the adviser, resulting in commissions of approximately $98,000. These investment products were not suitable for the clients. In fact, one annuity's producers had a policy against the sale of the product to individuals over the age of 75. The adviser’s registration was suspended for four months, she was fined $25,000, and she was prohibited from selling variable annuities or handling accounts for individuals over the age of 65 for five years. [*See* http://www.sos.mo.gov/securities/orders/AP-06-47.asp].

• FINRA suspended an investment adviser for six months and levied a fine of $28,000 against the adviser when the adviser sold unsuitable variable annuities to seniors. [*See* http://www.nasd.com/PressRoom/NewsReleases/2004News Releases/NASDW_002828].

• FINRA barred an investment adviser from association with any FINRA-regulated securities firm and ordered the adviser to pay more than $1.5 million in restitution to seniors and other customers for unsuitable sales of variable annuities and mutual funds totaling over $6 million. [*See* http://www.nasd.com/PressRoom/ NewsReleases/2004NewsReleases/NASDW_002860].

• FINRA fined a financial services firm, $2.75 million for failing to maintain an adequate supervisory system to oversee the variable annuity sales activities of over 1,000 branch managers. working in offices throughout the United States. In a related action, FINRA permanently barred one of those branch managers because the manager recommended unsuitable variable annuity products to seniors and made misleading statements to customers in correspondence.
[*See* http://www.nasd.com/PressRoom/NewsReleases/2007NewsReleases/NASDW_018681]

• FINRA fined an investment services firm, $850,000 for supervisory, recordkeeping, telemarketing, and other violations. The firm had failed to implement proper procedures for selling variable annuities to seniors.
[*See http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW_017657*]

• NYSE fined a firm $550,000 for making unsuitable sales of variable annuities. The $550,000 penalty included a $175,000 fine and $375,000 to be used to compensate injured customers. [*See David A. Noyes & Co., Inc.*, Decision 05-98 (NYSE Hearing Panel November 9, 2005)].

• NYSE disciplined a registered representative for sales practice violations involving the sale of unsuitable variable annuities to seniors. [*See Steven Allen Koch*, Decision 05-104 (NYSE April 12. 2007)].

Early Retirement

Commonly, individuals provide misleading advice to seniors about early retirement schemes. The individuals mislead seniors into cashing in their company retirement savings and reinvesting the money, promising that the seniors will be able to live comfortably off the proceeds for the rest of their lives. People who have built up sizeable retirement savings have been misled and harmed by flawed and fraudulent early-retirement investment schemes. The following are examples of situations that have triggered investigations.

Examples

• FINRA brought a claim against a brokerage when the brokerage failed to supervise a broker who lured long-term employees of Exxon Corporation into retiring prematurely. The broker made unreasonable and exaggerated promises of high returns from reinvested funds from their company retirement plans. FINRA fined the brokerage $2.5 million for failure to supervise and required it to pay $13.8 million in restitution to 32 former Exxon employees. [*See http://www.nasd.org/PressRoom/NewsReleases/2006NewsReleases/P017386*].

• FINRA fined a brokerage $3 million and ordered it to pay $12.2 million in restitution to more than 200 former BellSouth employees. The brokerage failed to supervise a team of brokers who used misleading sales materials during dozens of retirement seminars and meetings for hundreds of employees of BellSouth Corporation. FINRA found that the brokers' sales materials and presentations did not disclose that the recommended investments exposed the employees to greater market risk than their fixed annuity pension payments from BellSouth. As a result of these omissions and misrepresentations, BellSouth employees believed they could afford to retire early by relying upon monthly withdrawals from their retirement savings. Relying on the brokers' representations, many of the customers cashed out their nearly risk-free BellSouth pensions, their 401(k) accounts and other retirement assets and invested the proceeds with the brokers. [*See* http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/P019240].

• NYSE fined an investment firm $900,000 for its failure to supervise a branch office manager who made unsuitable trades in customer accounts. The manager held seminars in which he encouraged long-term factory workers to retire, sell their stock in the profit sharing plan, and invest the derived funds through him. He then employed a trading strategy that included the purchase of unsuitable stocks. In some instances, the manager executed unauthorized trades and exercised discretionary trading authority without the customers' prior written authorization. [*See A. G. Edwards*, Decision 06-133 (NYSE Hearing Board July 10, 2006)].

• NYSE fined a registered representative for various sales practice violations. The representative gave investment seminars to employees of an oil refinery who were offered lump-sum retirement payments in lieu of pensions. He recommended that retired or soon-to-be-retired customers should invest in technology-sector stocks that were unsuitable for the customers' investment experience, financial resources, and investment objectives. [*See Henry William Kalweit*, Decision 06-62 (NYSE October 4, 2006)].

Chapter 4 FINRA Rules

The Securities and Exchange Commission (SEC) approved the Financial Industry Regulatory Authority's (FINRA) new rules relating to variable annuity suitability and the supervision of variable annuity sales. FINRA includes the organization formerly known as the National Association of Securities Dealers (NASD). In July 2007, the SEC approved the formation of a new Self-Regulatory Organization (SRO) to be a successor to NASD. The NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange were then consolidated into the Financial Industry Regulatory Authority (FINRA).

FINRA Rule 2821 Governing Deferred Variable Annuity Transactions

On September 7, 2007, the SEC approved new NASD Rule 2821 regarding broker-dealers' compliance and supervisory responsibilities for deferred variable annuities. The rule became effective May 5, 2008.

Deferred variable annuities are hybrid investments containing both securities and insurance features. In general, a variable annuity is a contract between an investor and an insurance company whereby the insurance company promises to make periodic payments to the contract owner or beneficiary, starting immediately (an immediate variable annuity) or at some future time (a deferred variable annuity).

They offer choices among a number of complex contract options, which can cause confusion for both the individuals who sell them and customers who buy them. FINRA developed Rule 2821 to enhance broker-dealers' compliance and supervisory systems and provide more comprehensive and targeted protection to investors regarding deferred variable annuities.

Applies to Purchase or Exchange

Rule 2821 applies to the purchase or exchange (not sale or surrender) of a deferred variable annuity and the initial subaccount allocations (Rule 2821(a)(1)). The rule covers a stand-alone purchase of a deferred variable annuity and an exchange of one deferred variable annuity for another. For purposes of the rule, an "exchange" of a product other than a deferred variable annuity (such as a fixed annuity) for a deferred variable annuity would be covered by the rule as a "purchase." The rule does not cover customer sales or surrenders of deferred variable annuities, including the sale or surrender of a deferred variable annuity in connection with an "exchange" of a deferred variable annuity for another product (such as a fixed annuity).

Rule 2821 does not apply to reallocations of sub accounts made or to funds paid after the initial purchase or exchange of a deferred variable annuity. Other FINRA rules, however, are applicable to such transactions. For instance, FINRA's general suitability rule (NASD Rule 2310) continues to apply to any recommendations to reallocate subaccounts or to sell a deferred variable annuity. In a 2002 *Regulatory & Compliance Alert* entitled "Reminder—Suitability of Variable Annuity Sales," The Financial Industry Regulatory Authority (FINRA) emphasized that Rule 2310 "…applies to any recommendation to sell a variable annuity regardless of the use of the proceeds, including situations where the member recommends using the proceeds to purchase an unregistered product such as an equity-indexed annuity. Any recommendation to sell the variable annuity must be based upon the financial situation, objectives and needs of the particular investor." *Regulatory & Compliance Alert* (Spring 2002) at 13. As part of the suitability analysis under Rule 2310 regarding a recommendation to sell a deferred variable annuity, a registered representative must consider, *inter alia*, tax consequences, surrender charges and loss of benefits (such as death, living or other contractual benefits). A registered representative, also called a stock broker or an account executive, is an individual who is licensed to sell securities and has the legal power of an agent.

Funding IRAs

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. A deferred variable annuity purchased to fund an IRA (or other tax deferred account or vehicle) does not provide any additional tax deferred treatment of earnings beyond the treatment provided by the IRA (or other tax deferred account or vehicle) itself. Accordingly, where a customer is purchasing a deferred variable annuity to fund an IRA (or other tax deferred account or vehicle), firms must ensure that features other than tax deferral make the purchase of the deferred variable annuity for the IRA (or other tax deferred account or vehicle) appropriate.

Another issue involving this rule is whether Rule 2821 would apply if a registered representative recommended a deferred variable annuity to an individual retirement plan participant and the annuity was the only funding vehicle for the employer's retirement plan. If the registered representative "recommends" the deferred variable annuity, then Rule 2821 would apply. However, not all communications about a deferred variable annuity would constitute a "recommendation" that triggers application of the rule. For instance, a firm's generic communication to plan participants indicating only that their employer has chosen a deferred variable annuity as the funding vehicle for its retirement plan generally would not constitute a "recommendation" triggering application of the rule.

The Rule's Main Requirements

Rule 2821 has the following four main requirements. Keep in mind that this is an overview. Firms and their associated persons should carefully review the actual rule language in order to understand the breadth of the obligations that the rule imposes.

1. Registered Representative Requirements for Recommended Transactions
2. Principal Review and Approval Obligations for All Transactions
3. Firm Supervisory Procedures
4. Firm Training Program

1.) Product Suitability

Under the "Recommendation Requirements" section of the rule, (Rule 2821(b)) a registered representative must have a reasonable basis to believe that the customer has been informed, in general terms, 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. Rule 2821(b)(1)(A)(i).While the rule does not specify the exact type or form of disclosure that is required, a registered representative who merely delivers a prospectus to an investor ordinarily would not have a reasonable basis to believe that the customer has been instructed or educated—"informed"— about the material features of a deferred variable annuity for purposes of the rule.

Although the rule requires only generic disclosure, registered representatives and principals may not ignore product-specific features. For example, a firm and its brokers cannot adequately determine the suitability of a transaction without knowing the material features of the deferred variable annuity in question. A broker's understanding of the features of an investment product is an important component of both reasonable-basis suitability (*i.e.*, the requirement that a broker determine, after appropriate due diligence, whether the product is suitable for at least *some* investors) and customer-specific suitability (*i.e.*, the requirement that the broker determine whether the product is suitable for the particular customer at issue). *See NASD Notice to Members 03-71* (Nov. 2003).

Customer to Benefit

This section of the rule also requires that the registered representative 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. In the past, it was apparent that some brokers and investors did not fully understand important aspects of these features. For instance, "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. "*NASD Notice to Members 99-35* (May 1999). *See also NYSE Information Memo 05-54* (Aug. 11, 2005) ("A customer of advanced years might lack the actuarial expectations necessary for a deferred variable annuity to yield its benefit of income shelter versus costs, and his or her lower tax bracket might render such benefits marginal or negative."). The rule does not require that a registered representative determine that the customer would benefit from *all* of these features or that the customer, in hindsight, actually took advantage of one or more of them.

Further, this section states that a registered representative must have a reasonable basis to believe that "the particular 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.…" [Rule 2821(b)(1)(A)(iii)]. Thus, the suitability determination must include careful consideration of the product in its entirety and its component parts, including initial subaccount allocations.

If an “exchange” of one variable annuity for another is involved, the registered representative must have a reasonable basis to believe that “the transaction as a whole also is suitable for the particular customer” and must consider a number of additional factors. 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 36months.” [Rule 2821(b)(1)(B)].

Regarding the last factor, a registered representative must determine whether the customer has effected another exchange at the broker-dealer at which he or she is performing the review and must make reasonable efforts to ascertain whether the customer has effected an exchange at any other broker-dealer(s) within the preceding 36 months. FINRA generally would view asking customers whether they had an exchange at another broker-dealer within 36months to be a “reasonable effort” in this context.

Customer-Specific

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. This information includes 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.” [Rule 2821(b)(2)].

Although not explicitly addressed in the rule, deferred variable annuities generally are considered to be long-term investments and are therefore typically not suitable for investors who have short-term investment horizons. Finally, 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 Rule 2821.

2.) Principal Review and Approval Obligations for All Transactions

The rule’s “Principal Review and Approval” section includes both timing and substantive components. With regard to timing, the rule requires review and approval “[p]rior 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 the customer signs the application.…” [Rule 2821(c)]. FINRA recognizes that (in view of the variety of features and provisions of deferred variable annuity contracts) principal review of these investments often can require more time than reviews of many other types of securities transactions. To ensure that broker-dealers have sufficient time for a rigorous and thorough review prior to transmittal, FINRA has provided interpretive relief and the SEC has provided an exemption (as described below) regarding a number of rules that otherwise might have, as a practical matter, shortened the period within which broker dealers could review the transactions.

Payment Receipt Triggers

Broker-dealers often accept customer checks made payable to the issuing insurance company when customers sign applications for deferred variable annuities. The Broker dealers' receipt of the checks, however, could have triggered application of a number of other rules that might have required relatively quick principal reviews. NASD Rule 2330, for instance, generally prohibits improper use of customer funds, and NASD Rule 2820 specifically requires broker-dealers to "transmit promptly" the application and purchase payment for a variable annuity contract to the issuing insurance company. To alleviate the potential conflict between Rule 2821's 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 business days without violating either Rule 2330 or Rule 2820 if the reason for the hold is to allow completion of principal review of the transaction pursuant to Rule 2821. An SEC exemption also was needed because "[m]any broker-dealers are subject to lower net capital requirements under [SEC] Rule 15c3-1 and are exempt from the requirement to establish and fund a customer reserve account under [SEC] Rule 15c3-3 because they do not carry customer funds or securities." [SEC Order Granting Exemption to Broker-Dealers from Requirements in Rules 15c3-1 and 15c3-3 to Promptly Transmit Customer Checks (Exemption Order), Securities Exchange Act Release No. 56376 (Sept. 7, 2007), 72 FR 52400 (Sept. 13, 2007)].

Although some of these firms receive checks from customers made payable to third parties, the SEC does not deem a firm to be carrying customer funds if it "promptly transmits" the checks to third parties. [*See* Securities Exchange Act Release No. 31511 (Nov. 24, 1992) (stating that a firm shall not be deemed to receive funds if checks are payable to an entity other than itself—such as to another broker-dealer or escrow agent—and the firm promptly forwards such funds to the third party)].
The SEC has interpreted "promptly transmits" to mean that "such transmission or delivery is made no later than noon of the next business day after receipt of such funds or securities." [As above, note 11, and 17 CFR §240.15c3-1(c)(9). The SEC has extended this definition to SEC Rule 15c3-3(k). *See* NYSE's SEC Rule Interpretations Handbook, at 15c3-3(k)(2)(ii)/015].

Promptly Transmit

In conjunction with its approval of Rule 2821, the SEC provided an exemption to the "promptly transmits" requirement under the following conditions:

- The transaction is subject to the principal review requirements of 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 in accordance with the rule;

- 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
- 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.

If all three of these conditions are met, a firm is "exempt from any additional requirements of [SEC] Rules 15c3-1 or 15c3-3 due solely to a failure to promptly transmit a check made payable to an insurance company for the purchase of a deferred variable annuity product by noon of the business day following the date the broker dealer receives the check from the customer.…" [Exemption Order, *supra*].

During the rulemaking process, some commenters asked whether principals must complete or simply begin their review prior to the transmittal of the application to the issuing insurance company. The principal review must be *completed* before transmittal of the application to the insurance company.

A coalition of 32 life insurance companies asked whether the timing of principal review under Rule 2821 would be impacted by a firm's status as a "captive broker-dealer." The coalition explained that a number of insurance companies share personnel with affiliated broker-dealers and have centralized units that may share personnel who are responsible for both the broker-dealer's principal review of the variable annuity application and the insurance company's issuance process. The coalition sought clarification that receipt of customer applications by broker-dealer personnel for principal review, even if those personnel share office space with and/or also work for the insurer, would not be considered "transmitted to the issuing insurance company for processing" under Rule 2821.

Principal Review Issues

To respond to the coalition's request for clarification, it is necessary to emphasize that the main purpose of requiring pre-transmittal principal review is to have the principal review and determine whether to approve the application *prior to the issuance of the contract.* Ordinarily, FINRA would consider the application "transmitted" to the insurance company when the broker-dealer sends the application to the insurance company for processing, whether it is sent via electronic means, facsimile transmission, regular or overnight mail, or courier. The dividing lines can become blurred, however, when a captive broker-dealer and insurance company share office space and/or employees who carry out both the principal review and the issuance process. In such situations, FINRA considers the application "transmitted" to the insurance company only when the broker-dealer's principal, acting as such, has approved the transaction, provided that the affiliated broker-dealer ensures that arrangements and safeguards exist to prevent the insurance company from issuing the contract prior to principal approval by the broker-dealer. Several commenters have asked, in the case where a captive broker-dealer shares office space and/or employees with the insurance company, whether, in advance of the broker dealer's principal approval of the transaction, the customer's funds could be deposited in an account at the insurance company and administration of the issuance processing could begin. The rule does not permit depositing the customer's funds in an account at the insurance company prior to completion of principal review. The rule, however, does not prohibit using the information required for principal review and approval in aid of the issuance process. For instance, the rule generally does not prohibit a broker-dealer from inputting information used as part of its suitability review into a shared database (irrespective of the media used for that database, *i.e.*, paper or electronic) that the insurer uses for the issuance process, provided that no further steps are taken in the issuance process.

In addition to addressing the timing of principal review, this section of the rule states that a principal shall treat "all transactions as if they have been recommended for purposes of this principal review" and shall only approve the transaction if he or she determines "that there is a reasonable basis to believe that the transaction would be suitable based on the factors delineated in paragraph (b) of this Rule." [Rule 2821(c)].
A principal who determines that the transaction is unsuitable none the less 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.

Narrow Circumstances

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 the narrow circumstances discussed above. Thus, the rule has no effect on existing principles of law or contractual terms that allow a broker-dealer to decline the acceptance of an order.

A few commenters asked whether principals have amore limited role under the rule if they are employed by a broker-dealer that does not have a sales force and does not make recommendations to customers. One commenter asked whether Rule 2821 applies to an issuer's direct sale of a deferred variable annuity to a customer without any involvement of a broker-dealer or persons associated with a broker-dealer. FINRA's rules apply only to member broker-dealers and their associated persons. FINRA notes, however, that the determination of whether an entity should be registered as a broker-dealer rests with the SEC.
The rule requires that a broker-dealer have procedures in place designed to ensure that principals receive appropriate information about both the customer and the product(s) so that they can fulfill their review obligations under the rule and that principals review *all* purchase and exchange orders for suitability, irrespective of whether the orders were recommended.

3.) Firm Supervisory Procedures

The rule specifically requires broker-dealers to establish and maintain written supervisory procedures reasonably designed to achieve compliance with the standards set forth in the rule. [*See* Rule 2821(d)].

Surveillance Implementation

This part of the rule includes the requirements that the broker dealer implement surveillance procedures to determine if any "*associated persons* have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of this Rule, other applicable NASD rules, or the federal securities laws ('inappropriate exchanges') and have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges.…" [(emphasis added). FINRA notes that Rule 2821(d)(1) focuses on whether an *associated person* has effected an inappropriate number of exchanges, while Rule 2821(b)(1)(B)(iii) focuses on whether a particular *customer* has had another exchange within a 36-month period].
The rule allows a firm to determine how to screen for and supervise such activity. Thus, a firm could perform this type of review on a periodic basis via exception reporting rather than as part of the principal review of each exchange transaction.

4.) Firm Training Program

The fourth main requirement in the rule is a training component, which requires that firms create training programs for registered representatives who sell, and for registered principals who review transactions in, deferred variable annuities [Rule 2821(e)]. Among other factors, firms must include training on the material aspects of deferred variable annuities.

Use of Automated Supervisory Systems

Rule 2821 does not preclude firms from using automated supervisory systems (or a mix of automated and manual supervisory systems) to facilitate compliance with the rule. Of course, firms that intend to rely on automated supervisory systems for compliance with Rule 2821 (or other rules)must remember that, at a minimum, a principal or principals would need to;
(1) approve the criteria that the automated supervisory system uses;
(2) audit and update the automated supervisory system as necessary to ensure compliance with the rule; and
(3) review exception reports that the automated supervisory system creates. As is always the case with the exercise of supervision under FINRA rules, the use of any automated supervisory system, aid or tool for the discharge of supervisory duties represents a direct exercise of supervision by the supervisor (a principal or principals under Rule 2821) and the supervisor remains responsible for the discharge of supervisory responsibilities in compliance with the rule. Consequently, a principal or principals relying on such an automated supervisory system is responsible for any deficiency in the system's criteria that would result in the system not being reasonably designed to comply with Rule 2821.

A broker-dealer need not designate only one principal to perform these tasks. Consistent with NASD Rules 3010 and 3012, a broker-dealer generally is free to allocate supervisory responsibilities among its qualified registered principals as appropriate (whether in the context of automated or manual supervisory reviews). Thus, a broker dealer may, for example, designate several principals to be responsible for various parts of an automated supervisory system. Finally, a broker-dealer must ensure that it provides training for;

(1) the firm's relevant associated persons on how to correctly input information into the automated supervisory system and
(2) the firm's principals responsible for reviewing and approving deferred variable annuity transactions on how to use and interpret the reports generated by the firm's automated supervisory systems in order to properly review and monitor deferred variable annuity transactions.2727 The firm also would need to comply with applicable requirements of NASD Rule 3110 and SEC Rules 17a-3 and 17a-4 and interpretations thereof.