

# Notice to Members

AUGUST 2005

## SUGGESTED ROUTING

Legal & Compliance  
Operations  
Registered Representatives  
Senior Management  
Executive Representatives  
Insurance  
Variable Contracts

## KEY TOPICS

Equity-Indexed Annuities  
Rule 3030 (Outside Business Activities  
of an Associated Person)  
Rule 3040 (Private Securities Transactions  
of an Associated Person)  
Supervision

## GUIDANCE

### Equity-Indexed Annuities

Member Responsibilities for Supervising Sales  
of Unregistered Equity-Indexed Annuities

#### Executive Summary

This *Notice to Members* addresses the responsibility of firms to supervise the sale by their associated persons of equity-indexed annuities (EIAs) that are not registered under the federal securities laws.<sup>1</sup>

#### Questions/Further Information

Questions concerning this *Notice* may be directed to Thomas M. Selman, Senior Vice President, Investment Companies/Corporate Financing, (240) 386-4500.

#### Background and Discussion

Equity-indexed annuities are financial instruments in which the issuer, usually an insurance company, guarantees a stated interest rate and some protection from loss of principal, and provides an opportunity to earn additional interest based on the performance of a securities market index. Some EIAs are not registered under the Securities Act of 1933 (the Securities Act) based on a determination that they are insurance products that fall within that statute's Section 3(a)(8) exemption and therefore are not considered to be securities.<sup>2</sup>

According to one recently published estimate, in 2004 sales of equity-indexed annuities increased over 50 percent, from \$14 billion in 2003 to an estimated \$22 billion.<sup>3</sup>

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## 1. Investor Protection Issues Presented by Equity-Indexed Annuities

EIAs are complex investments. Many EIAs permit investors to participate in only a stated percentage of an increase in an index. Many of these investments also impose a "cap rate" that represents the maximum annual account value percentage increase allowed to investors. Unregistered EIAs typically do not provide for investor participation in the dividends accumulated on the securities represented by the index.<sup>4</sup> EIAs have other features that contribute to their complexity such as minimum guarantees and fees and expenses, including surrender charges, premium bonuses, and multiple premium payment arrangements. In addition, investors may assume mistakenly that EIAs provide the same returns as an index mutual fund.

NASD is concerned about the manner in which associated persons are marketing and selling unregistered EIAs, and the absence of adequate supervision of these sales practices. We have seen sales material for unregistered EIAs that do not fully describe the features and risks of the product. For example, we have seen the following claims:

- ◆ "What if the market goes down and you would lose nothing? The market goes up-you gain!"
- ◆ "A Win/Win Investment Vehicle!"
- ◆ "How Your Retirement Funds Can Have: Security of Principal, Higher Than CD Rates of Interest, Opportunity for Growth (No Losses)"
- ◆ "Pick up where Social Security leaves off with NEW tax-deferred annuities...featuring... 2 indexed accounts linked to a popular stock market index."
- ◆ If you're looking for upside potential and no market downside look no further than [name of EIA]. This fixed annuity... enables you to make the most of S&P 500 Index gains..."
- ◆ "Growth Potential *without* Market Risk."

We understand that some associated persons who also act as insurance agents might be using this type of sales material in their insurance sales capacity. NASD is concerned that the unsupervised use of such sales material could confuse or mislead investors. If sales pieces containing these statements were deemed to be broker-dealer communications with the public, then they would be subject to the NASD advertising rules, and would have to provide a balanced description of the features and risks of the product.

Moreover, because of the product's complexity, some associated persons might have difficulty understanding all of the features of the product and determining the extent to which those features meet the needs of the customer. While unregistered EIAs may be appropriate for some retail investors, they are not suitable for all investors. For example, possible surrender charges and the combination of caps and participation rates associated with a particular product are factors that must be considered in any suitability determination.

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## 2. The Uncertain Status of Unregistered Equity-Indexed Annuities

The question of whether a particular EIA is an insurance product or a security is complicated and depends upon the particular facts and circumstances concerning the instrument offered or sold. NASD does not seek to resolve that issue in this *Notice*; nor is this *Notice* intended to describe those circumstances in which an EIA might be deemed to be a security. However, a brief summary of the applicable provisions of the federal securities laws may be useful.

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

In 1986, the Commission adopted Rule 151, a "safe harbor" under the Securities Act, which clarifies when certain annuity contracts are exempted securities under Section 3(a)(8). The fundamental construct of Rule 151 is derived from prior judicial interpretations of Section 3(a)(8). Consequently, the Commission has stated that the rationale underlying the conditions set forth in the rule are, along with applicable judicial interpretations, relevant to any Section 3(a)(8) analysis.<sup>5</sup>

In order for the Rule 151 safe harbor to apply:

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

As noted above, the status of any particular EIA under the safe harbor (or under Section 3(a)(8)) will depend on the facts and circumstances. In 1997 the Commission issued a concept release requesting comment regarding EIAs.<sup>6</sup>

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### 3. Supervision under Rule 3030 and Rule 3040

Many firms assume that EIAs that are not registered under the Securities Act are insurance products and not securities. These firms treat the sale of unregistered EIAs by associated persons in their capacity as insurance agents as an outside business activity under Rule 3030, beyond the mandated purview of the firm's supervision. Rule 3030 does not require that the firm supervise or even approve an outside business activity, although a firm may choose to deny or limit the ability of associated persons to engage in the activity. Rule 3030 simply requires that an associated person promptly notify the firm in writing that he is engaging in a business activity outside the scope of his relationship with the firm.

However, if a particular EIA were a security, and an associated person sold the EIA outside the regular scope of his employment with the firm, Rule 3040 requires that the firm treat the sale as a private securities transaction and supervise the sale in accordance with the provisions of that rule. The associated person must notify the firm in writing before participating in a private securities transaction. If the associated person will receive compensation for the transaction, the firm must provide written approval of his participation in the transaction. If the firm does approve the participation, it must record the transaction on its books and records and supervise the associated person's participation in the transaction as if the transaction were executed on behalf of the firm.

A broker-dealer runs certain risks in applying Rule 3030 to the sale of an unregistered EIA on the assumption that the product is not a security. It is often unclear whether a particular EIA qualifies for the exemption under Section 3(a)(8), since the analysis is made on a case-by-case basis and may turn on the particular features and marketing materials associated with the product. As a result, if a particular EIA did not qualify for the exemption, a firm might incorrectly treat the EIA transaction as an outside business activity under Rule 3030 rather than a private securities transaction under Rule 3040 and thereby fail to supervise sales of the product as required by NASD rules.

Perhaps for these reasons, some firms require that associated persons obtain firm approval to sell exempt insurance products. Other firms require that their associated persons obtain more specific approval to sell unregistered EIAs. Still other firms maintain a list of approved EIAs and prohibit the sale of all others.

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#### 4. Supervisory Measures

Due to the uncertainty as to whether a particular unregistered EIA may be a security, as well as the potential regulatory violations and investor protection issues that would arise by the marketing and sale of unregistered EIAs that are deemed to be securities, firms must adopt special procedures under Rule 3030 with respect to these products. In particular, firms must require that their associated persons promptly notify the firm in writing when they intend to sell unregistered EIAs. Moreover, all recommendations to liquidate or surrender a registered security such as a mutual fund, variable annuity, or variable life contract must be suitable, including where such liquidations or surrender are for the purpose of funding the purchase of an unregistered EIA.

As discussed above, NASD is not taking a position on whether a particular EIA is a security, nor are we attempting to describe the circumstances in which an EIA would be deemed a security. However, the uncertainty of this matter has led some firms to treat an associated person's sale of an unregistered EIA outside the regular course or scope of his employment with the firm, as a private securities transaction. These firms supervise the sale according to Rule 3040 procedures. Firms are well advised to consider whether they should take a similar approach. Firms should consider maintaining a list of acceptable unregistered EIAs and prohibiting their associated persons from selling any other unregistered EIA, unless the associated person notifies the firm in writing that he intends to recommend an unregistered EIA that is not on the firm's list, and receives the firm's written confirmation that the sale of the unregistered EIA is acceptable.

Firms are encouraged to consider whether other supervisory procedures also might help protect the firm's customers. For example, a firm could require that all sales of unregistered EIAs occur through the firm. If an associated person is selling the unregistered EIA through the firm, the firm must supervise the marketing material, suitability analysis, and other sales practices associated with the recommendation of unregistered EIAs in the same manner that it supervises the sale of securities.

Firms also must provide any associated person selling any unregistered EIA through the firm with the proper training to understand the EIA's features and the extent to which the EIA meets the needs of a particular customer. The fact that an associated person holds a license as an insurance agent may not adequately qualify him to understand the features of an EIA or the extent to which an EIA meets the needs of a particular customer.

Of course, in this as in all other areas, NASD expects every associated person to comply with the procedures adopted by his firm.

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## Endnotes

- 1 The sale of an EIA registered under the federal securities laws is subject to the full panoply of regulation applicable to the sale of any security.  
  
The principles articulated in this *Notice* apply to EIAs that are sold by associated persons of a broker-dealer, whether the EIA has been manufactured by an insurance company that is affiliated with the broker-dealer or by an unaffiliated insurance company.
- 2 The Securities and Exchange Commission (the Commission) has previously stated that Congress intended any insurance contract falling within Section 3(a)(8) to be excluded from all provisions of the Securities Act notwithstanding the language of the Act indicating that Section 3(a)(8) is an exemption from registration but not the antifraud provisions. See Definition of "Annuity Contract or Optional Annuity Contract," Securities Act Release No. 6558 (Nov. 21, 1984), 49 Fed. Reg. 46750; 46753 (Nov. 28, 1984).
- 3 "A Do-It-Yourself Kit for Investors: Build Your Own Equity-Indexed Annuity," *The Wall Street Journal* (January 26, 2005).
- 4 The index return may be calculated in a variety of ways, such as the "annual reset" method, under which the index starting point is reset each contract year; the "point-to-point" method, under which the change in the index from the start of a term is compared to the index at the end of the term; and the "annual high-water mark with look-back" method, which is a variation on the point-to-point method except that it compares the index starting point to the highest anniversary value during the term.
- 5 Securities Act Release No. 6645, 35 SEC Docket 952 (May 29, 1986) (adopting Rule 151) ("Adopting Release").
- 6 Request for Comment on Equity-Indexed Products, Securities Act Release No. 7438; File No. 57-22-97 (August 20, 1997). At least one court has ruled on the question of whether an EIA is a security. The court granted a motion to dismiss based upon the finding that the EIA, which was the subject of litigation, in that case was exempt from the federal securities laws. See *Malone v. Addison Insurance Marketing*, 225 F. Supp. 2d 743 (W.D. Ky. 2002).

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