2017 FINRA 2330 VA Training Module — All Registered Associated Persons

Purpose of Module

The purpose of this training module is to ensure all Registered Associated Persons (“RAPs”) understand the material features of Deferred Variable Annuities (“VAs”), as well as the underlying requirements of FINRA Rule 2330 (a.k.a. NASD 2821), Members’ Responsibilities Regarding Deferred Variable Annuities. This Rule applies to the initial purchase or exchange of a VA and the sub-account allocations.

IMPORTANT: You will be required to complete a quiz in conjunction with this module in order to gain CE credit. You must receive a score of 80% to pass the quiz.

Background of Rule 2330

FINRA Rule 2330, Members’ Responsibilities Regarding Deferred Variable Annuities, is comprised of four primary components: I) Recommendation/Suitability, II) Supervisory Procedures, III) Training and IV) Principal Review and Pre-Approval prior to submission to the carrier and within (7) business days of submission to the Principal. The suitability and training components of the Rule became effective May 5, 2008, while amendments to the supervisory procedures and Principal pre-review elements became effective February 8, 2010.

I. Recommendation/Suitability Requirements

FINRA has continued to focus on the sale and documentation of Variable Annuities. The following FINRA 2330 VA Training Module is designed to educate and train our RAPs regarding the different types of VAs, features and benefits of VAs. In addition to the standard definition of a VA, the FINRA 2330 VA Training Module will provide guidance related to suitability red flags as well as documentation requirements related to the processing of VA business.

Initial VA Recommendation

With respect to suitability, RAPs must comply with FINRA Rule 2330 in addition to general suitability standards set forth by FINRA Rule 2111, which requires the following:

- RAPs must have a reasonable basis to believe that sales of variable insurance products are suitable to the client’s needs. RAPs are required to conduct a thorough suitability determination for all (initial transactions, exchanges and subsequent purchases). RAPs must document all suitability reviews imputing data elements, including rider and sub-account information, into the EOE workflow system (“EOE”).

- The customer must be informed, in general terms, of various features of deferred variable annuities, such as the potential surrender period and surrender charge; potential tax penalty if customers sell or redeem deferred variable annuities before reaching the age of 59½; Mortality & Expense and Administrative fees (“M&E&A”); investment advisory fees; potential charges for and features of riders; the insurance and investment components of deferred variable annuities; and market risk.

- The customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit.

- The RAP must consider the suitability of a particular VA as a whole, documenting via EOE, the suitability of the underlying sub-accounts to which funds are allocated at the time of the purchase. RAPs must also consider whether an exchange of a VA, riders and similar product enhancements, if any, are suitable; and, in the case of an exchange, the transaction as a whole also is suitable.

The RAP must sign the suitability determination related to the purchase of the VA. By submitting via the Firm’s EOE workflow, the RAP’s EOE submission of the transaction constitutes their documentation, “signature” and acknowledgement for the purpose of this Rule. This includes transactions entered and submitted by an administrative assistant at the direction and on the behalf of the RAP. RAPs are reminded that that Firm policy requires all subsequent VA transactions are entered and submitted within the Firm’s EOE workflow. RAPs are required to provide a detailed description along with the rationale.
regarding the purchase of a VA. RAPs are required to ensure that the VA Sub-Account allocation is suitable with respect to the clients' risk tolerance, investment objective. RAPs are reminded that client's total VA exposure should not be overly concentrated with respect to the clients' liquid net worth.

Suitability “Red Flags”

Special Suitability Considerations/ “Red Flags” — Initial Purchases
Each RAP has an obligation to assess many factors in determining whether a variable annuity will be suitable for a client. In turn, Supervisors also have an obligation to review these factors and make a determination of whether they, too, feel the VA purchase or exchange is suitable for the client. Ultimately, Supervisors have the right to reject any VA transaction they feel is detrimental to the client or does not adequately meet the client’s needs.

Regulators such as FINRA and the Securities and Exchange Commission consistently express concerns about the complex variety of features and accompanying fees and charges available in variable annuities. They are also concerned as to the manner in which clients may be sold a variable annuity without fully understanding its features and expenses.

These concerns, reflected by enforcement actions taken against advisors and broker/dealers for deficiencies in their suitability determination process, can make the suitability analysis conducted by a RAP extremely complex.

In conducting suitability analysis, potential issues or concerns surrounding a client’s purchase of a variable annuity, i.e., “Red Flags,” may be noted. It is important to remember that while a “Red Flag” may arise, it does not imply that an advisor has acted inappropriately, nor does it imply that a transaction is not suitable.

Essentially, a “Red Flag” is a signal that a particular issue requiring heightened scrutiny is exhibited in a pending transaction. As with all suitability issues, RAPs must document and evidence the process they have taken to know their client and the product proposed.

The following non-exhaustive list of “Red Flags” and considerations are offered in an attempt to assist RAPs and Supervisors in conducting the suitability review and approval process.

- **CDSC/Replacement or Transfer with Client Incurring a CDSC/CDSC Schedule with Duration Longer than Client’s Investment Horizon**
  CDSC schedules normally decline gradually over the course of 4 to 10 years, and can range from 10% to 1% of a client’s variable annuity cash value. Because a variable annuity is considered a long-term investment, exchanging a variable annuity prior to the expiration of all CDSCs could indicate the sale is premature.

  Transactions exposing a client to any CDSC must be fully explained relative to the advantages gained in light of the charges incurred.

  In the event that a proposed variable annuity has a CDSC schedule with a duration longer than a client’s stated investment horizon, a complete explanation is necessary describing why the variable annuity is the appropriate product in light of the client’s shorter investment horizon. That is, why is it suitable for the client to purchase the variable annuity if their horizon may require withdrawals that incur CDSCs?

- **Client Older than 65/ “Locking” a Client over 65 into a CDSC Cycle**
  A variable annuity can be an excellent product for individuals over the age of 65. However, the product’s complexities, the relative unsophisticated nature of some seniors and the “high pressure” tactics utilized by some industry representatives have heightened the scrutiny the regulators direct at variable annuity sales to seniors.

  While RAPs should always review, and document their efforts in discussing the following issues/questions with a client or potential client, the RAP must be confident that a senior is aware of, and fully understands, the following:

  - Liquidity Issues: Is the senior's investment horizon such that it is likely withdrawals will incur CDSCs? If so, is an alternative product more advantageous? RAPs are to fully document the rationale for a senior committing their monies to a long-term vehicle in light of their objectives and the potential for incurring CDSCs, in the event withdrawals become necessary. In considering the likelihood of such premature
withdrawals, the senior’s ability to access emergency funds, long-term care and other possible needs should be considered.

- Fees and Expenses: Are the fees and expenses appropriate in light of the benefits to the client or would an alternative product with fewer fees and expenses provide the same relative level of benefits, in light of the client’s objectives, age and investment horizon?

- Market Risk: Explain how the client’s investment experience, objectives, stated risk tolerance and time horizon are applicable to the market risk assumed by the client. Does the client understand the risks of losing principal?

- High Percentage of Client’s Liquid Net Worth in One or Numerous Variable Annuities
  FINRA and various state insurance departments have expressed significant concern about a client’s investable Liquid Net Worth being overly concentrated in one or more variable annuities.

  Investable, Liquid Net Worth is defined as assets that are cash or may be converted to cash in a readily available and liquid market. Jewelry, collectibles, homes and securities without a readily available market are not to be included in Liquid Net Worth. (See the Firm’s Compliance Guide, Section XI, Accounts, for a more detailed definition of Liquid Net Worth.)

  As a general rule, no more than 50% of an individual’s Liquid Net Worth should be invested in variable annuities.

- Qualified Rollovers
  The review of a qualified IRA rollover/transfer of qualified monies will be flexible relative to the above guidelines. Concentrations exceeding the guidelines are normally unavoidable and will be viewed in the context of the client’s entire financial situation.

Special Suitability Considerations/ “Red Flags” — VA Exchanges
The long-term nature of investing in a variable annuity requires that a RAP replacing one annuity with another annuity be able to fully and comprehensively explain why a new transaction is advantageous to the client. All transactions, whether funded by new money or through a transfer/replacement, must be in the economic interest of the client.

With respect to VA exchanges (including subsequent exchanges of existing contracts), aside from meeting general requirements related to VA suitability required FINRA Rule 2111, RAPs must also comply with additional components of FINRA Rule 2330 related to exchanges, which require the following:

- Assess whether the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living, or other contractual benefits), or be subject to increased fees or charges (such as M&E risk fees, investment advisory fees, or charges for riders and similar product enhancements).

- Determine whether the customer would benefit from product enhancements and improvements.

- Inquire whether the customer has had another VA exchange within the preceding 36 months.

- The RAP has to sign the suitability determination related to the exchange of the VA. By submitting via the Firm’s EOE workflow, the RAP’s submission of the transaction constitutes documentation, “signature” and acknowledgement for the purpose of this Rule.

The applicability of CDSCs, or lack thereof; the distinction and advantages offered by the characteristics and benefits of the new product over the old product; any potential disadvantages the variable annuity may pose to the client; the alternatives considered and the reasoning for the ultimate decision to purchase the variable annuity, based on the client’s goals and objectives, must be fully detailed. By providing this information comprehensively, the RAP evidences his/her understanding of the client’s needs.
Note: In Notice to Members 07-06, FINRA indicated that it is inappropriate to initiate an annuity replacement merely to allow a client to “follow an advisor” to a new company.

- **Replacements/Replacing a Contract Incurring Higher Fees than Previous Contract/Replacement of Contract In-Force for Fewer than 3 Years**
  
  A tax-free exchange can be useful to a client seeking another annuity with features they prefer, such as a larger death benefit, different and more advantageous annuity payout options, a wider selection of investment choices, a wider selection of riders, etc. **(Note: Seeking “better returns” is not an appropriate reason for an exchange because the past performance of any sub-account is not a guarantee of future performance. Clients should not initiate an exchange in order to “chase returns.”)**

- **Client Forfeiting Significant Death Benefit**
  
  In the event a client is liquidating a contract providing a death benefit, a detailed explanation must be provided.

  Examples of items to address include:
  - The age and health of the client;
  - The reason(s) the death benefit is no longer needed;
  - Whether a death benefit is still needed;
  - The manner in which the death benefit is now to be provided;
  - Whether the replacement death benefit is as economically priced as the replaced death benefit. If not priced as economically, how is such pricing advantageous to the client?

- **Short-Term Investment Time Horizon**
  
  FINRA has stressed that CDSC schedules, penalties for early withdrawals under the Internal Revenue Code and the potential for market volatility and losses over the short-term are factors that tend to make variable annuities relatively illiquid and an unsuitable investment for customers with a short-term time horizon and investment objective.

  Further, FINRA has specifically indicated that, while a variable annuity offers the benefit of tax-deferred accumulation, a minimum holding period is normally warranted so that the tax benefits can outweigh the higher fees normally associated with a variable annuity, as opposed to other investments, for example, mutual funds.

  Documentation should also address why the VA was the most suitable investment vehicle for the client.

- **Client in Lower Marginal Tax Bracket**
  
  One of the major benefits in purchasing a variable annuity is tax-deferred accumulation. Naturally, the benefits realized in a client’s real, after-tax net return are significantly heightened by a client’s relatively high tax bracket. However, the favorable tax treatment is not “free.” The various fees and expenses within a variable annuity may impact the tax advantages provided through deferral. Therefore, a client in a lower tax bracket might not benefit significantly from the tax-deferral features of a variable annuity.

  In the event a client with a lower tax bracket is sold a variable annuity, a detailed explanation concerning the advantages to the client, beyond tax deferral, is required. In this type of scenario, product features relative to income stream guarantees, death benefit or seeking to meet other objectives sought by the client must be provided.

  **Note:** In many ways, the issue of placing qualified monies into a variable annuity is very similar, i.e., qualified monies already provide tax deferral through the Internal Revenue Code. As such, when placing qualified monies in a variable annuity, “tax deferral” cannot be used as an advantageous reason for the transaction. Other advantages to the client must exist, and must be explained to the client and documented relative to product features or guarantees.
Sub-Account Selection Does Not Match Client’s Stated Objective/Risk Tolerance
As with any long-term investment, sub-account selections within a variable annuity should align with the stated risk tolerance and objectives of the client. In considering sub-accounts, the client’s awareness of their exposure to market risk and their ability to be comfortable with the possibility of loss of principal must be considered. Any deviations must be fully explained.

Specific to VAs, Supervisors should assess sub-account allocation at the time of the initial transaction, as part of the overall suitability of the purchase.

Bonus Annuities
There is a potential downside to a “bonus” annuity, and in proposing the purchase of a bonus annuity to a client there are a number of issues the client must understand. Frequently, insurers will charge the client for the “bonus” in one or more of the following ways:

- Higher Surrender Charges: Surrender charges may be higher than variable annuities without a “bonus.”
- Longer Surrender Periods: Purchase payments may be subject to longer surrender charge period schedules than non-“bonus” annuities.
- Higher M&E, Expense Risk and Other Charges: Some contracts may actually charge a separate fee specifically designed to pay for the “bonus.”
- Recapture of Bonus: In some instances, a “bonus” may be taken back by the insurer if a client makes a withdrawal, if a death benefit is paid or in other circumstances dictated by the terms and conditions of the contract.

Note: Under no circumstance should the “bonus” in and of itself be considered a reason for proposing a replacement. It is important to note the firm suspended sales of Bonus share products in March 2017.

Shorter surrender variable annuities
RAPs are reminded of the Firm’s heightened focus, as well as scrutiny from securities regulators of putting a client with a long-term time horizon in a shorter surrender variable annuity. Although some clients may benefit from the additional liquidity, the fees for either the shorter surrender buy-down or a C share annuity are higher. For this reason, the firm suspended sales of L share variable annuities effective January 11, 2016. Shorter surrender options are available on “bundled” variable annuity products as mentioned earlier.

C shares are fully liquid investments but typically carry higher Mortality, Expense and Administration (M&E&A) fees than B shares and are best suited for investors who are willing to pay higher fees in exchange for the ability to withdraw their investment at any time.

RAPs must keep in mind that there is a trade-off for the additional liquidity, including higher M&E&A fees which could result in lower returns compared to the performance of B shares with longer term holds. VAs are generally considered long term investments when offered with guaranteed living benefits or death benefits that are fully maximized by holding the contract for longer time periods or until the death of the annuitant.

As with all transactions, RAPs must ensure that VAs (including the share class elected) are suitable investments for their clients. Due to the additional issues and concerns with respect to the variations and differences between VA share classes, RAPs must also ensure their clients understand the share class options as well as the differences between the share classes, the RAPs recommendation is in the best interest of their client and that the client’s investment needs and objectives are met.

Clearly, there are many important factors related to the suitability and approval process for variable annuities. It is the responsibility of both RAPs and Supervisors to thoroughly assess and review these factors when recommending a purchase or exchange of a variable annuity. Our current policy requires a side-by-side comparison to the B share for any new purchases of a C share variable annuity, including applicable living and death benefits, which the client acknowledges and signs.
The first step in determining appropriate suitability for a particular client is to ensure that both the RAP and client understand the product features of variable annuities, as described in the following section.

Introduction
Variable annuities can be an important vehicle for accumulation, retirement and income planning. The tax-deferred growth of variable annuities may also be important in tax planning strategies and assisting clients in meeting their financial goals. However, there has been much scrutiny on the suitability of variable annuities due to their long-term investment nature, surrender schedules, fees and complexity.

Variable Annuity Overview
General Annuity Features
Annuities provide many features that offer a variety of investment options and potential benefits. Potential benefits include the following:

- Diversification within each portfolio and among investment choices to help reduce risk.
- Professional management among investment options.
- Tax-deferred growth of earnings (if any) until withdrawn. Withdrawals prior to age 59½ may be subject to a 10% IRS tax penalty.
- Ability to reallocate money between sub-account investment options inside the annuity without incurring a tax liability.
- Ability to allocate money to both a fixed interest rate sub-account (which is offered in many contracts) and stock and bond sub-account investment options — all within one product.
- No IRS annual limit to the amount invested (for non-qualified accounts).

The Annuity Contract
A variable annuity is a contract between the Contract Owner and an Insurance Company. During the “accumulation phase”, the Contract Owner may invest in various sub-accounts or fixed accounts in anticipation that at some point they may need to start taking income. During this time, the contract owner assumes the risk since the value of the contract is subject to market fluctuations. Once a contract reaches the “distribution phase”, the contract owner may wish to “annuitize” or begin taking periodic income payments from the insurance company. Once a contract is annuitized, the insurance company assumes the risk since they are guaranteeing the fixed income payments.

It is important to note that the performance of investment options within variable annuities are subject to market fluctuations and are not guaranteed. However, fixed investment options provide a guaranteed return as part of the insurance company’s general account and subject to the claims paying ability of the company. Living and death benefits discussed later are also backed by the claims paying ability of the company.

Parties to an Annuity Contract
Understanding the different parties to an annuity contract is critical. It is important to properly structure the annuity contract as it is a binding contract and in some cases may supersede any other type of estate planning contract:

- Contract Owner — The person with control of the contract. The person who is to receive annuitized payments.
- Annuitant — The person named by the Contract Owner upon whose life annuitization payments are based. The Contract Owner and the Annuitant can be, and often are, the same person.
- Beneficiary — The person who is the recipient of the death benefit upon the death of the Contract Owner or the death of the Annuitant, depending upon the contract terms.
RAPs need to be familiar with variations in annuity contracts with regard to the disposition of the annuity at the death of the Contract Owner and/or the Annuitant. Most contracts are “owner driven”, meaning the death benefit will pay to the beneficiary based on the death of the contract owner. However, in an “annuitant driven” contract, the death benefit will pay to the beneficiary only upon the death of the annuitant. In an annuitant driven contract, if the contract owner predeceases the annuitant (assuming the owner and annuitant are different), no death benefit is triggered but a new contract owner will need to be named. Incorrect positioning of the parties to the contract may result in unintended consequences and tax liabilities. It is important that RAPs understand the mechanics of the specific annuity being recommended.

**Death Benefit Features**
Variable annuities typically offer a death benefit or guaranteed payment to a beneficiary. Different products offer different benefits but can be generally summarized below and either are included in the contract or can be added for an additional fee:

- **Return of Premium** – guarantees your total investment (minus any withdrawals reduced either dollar-for-dollar or pro rata).
- **Highest Anniversary Value** – On the annual anniversary of the contract’s issuance, the account value is compared to that of all prior anniversaries. At death (of either Owner or Annuitant, depending on the contract), the highest anniversary value is paid to beneficiaries.
- **Annual Step-up.** The account value is guaranteed to increase annually at a set percentage (e.g., 3% a year). This feature may also be referred to as a ratcheted death benefit.
- **Earnings Enhancement.** In order to help beneficiaries offset estate taxes, some contracts pay the Beneficiary an additional percentage (e.g., 25% - 40%) of earnings. If there are no earnings in the contract at the time of death, there is no Earnings Enhancement benefit payable.

**Living Benefit Features**
One important benefit of variable annuities is income guarantee or living benefits. Many contracts offer multiple living benefit guarantees with different features, costs, investment restrictions and other complexities. RAPs need to be certain that they fully explain how a living benefit rider works to the client. The different types of living benefit riders are described below:

- **Withdrawal Benefit. Guaranteed Minimum Withdrawal Benefit (“GMWB”)** and **Guaranteed Minimum Withdrawal Benefit for Life. (“Lifetime GMWB”)** are designed to guarantee an income stream no matter the performance of the underlying investments. As the name suggests, Lifetime GMWBs guarantee income for as long as the contract owner lives, however, GMWBs will guarantee income typically for a set time frame (i.e. 10-years).
- **Income Benefit.** Guaranteed Minimum Income Benefits (“GMIB”s) offer a guaranteed minimum level of income in the form on an annuity payment (requires annuitization). GMIBs typically allow for the benefit base to grow at either a set percentage or based on market growth. Since annuitization is required, the longer the contract owner waits to take income, the higher the income amount. However, GMIBs also have certain features to be aware of including age restrictions, forced annuitization at certain ages and restrictions if the account value falls to $0.
- **Return of Premium.** Guaranteed Minimum Accumulation Benefits (“GMAB”s) guarantees the return of premium after a set time period, typically 5, 7, or 10 years. Some GMABs will lock in gains on a quarterly or annual contract anniversary, but may reset the waiting period.

Living benefit features can be complex so it’s important to know the nuts and bolts of each rider. Please keep in mind how the following may impact the rider or the income payout:

- Age restrictions on withdrawal amounts
- Single vs. Joint benefit differences
- Excess withdrawals
- Pro-rata vs. Dollar-for-Dollar decreases
Impact of RMDs
Step-ups and increased rider fees
Investment restrictions including volatility controlled strategies
Variable rider fees
Maximum rider fees
Account balances reduced to “$0”

RAPs must review these contract features with the client to ensure that the rider is suitable in light of the client’s objectives and time horizon, and that the client is eligible for any desired riders on the contract. Additionally, RAPs must clearly disclose and explain the different income and withdrawal features to clients and prospects so they understand the difference between these features and the ability to liquidate and receive the market value of the annuity.

Sub-account Features
Annuities generally permit investors to invest with one single sum, or flexible payments. A contract holder may then allocate assets among the different available sub-account investment options. RAPs should determine that the variable annuity contract as a whole, and the underlying sub-accounts recommended to the client, are suitable in light of the information provided on the client’s New Account Form for the particular registration. RAPs should monitor sub-account allocations on an ongoing basis to ensure they remain appropriate for the client based on their stated objectives and risk tolerances.

Guarantees
Any guarantees in a variable annuity contract, such as fixed investment options, death benefits, living benefits, and payout options, are made by the Insurance Company issuing the contract. There are several credit rating agencies (e.g., A.M. Best, Moody’s, Standard & Poor’s, etc.) that rate the financial strength and claims paying ability of insurance companies. The higher ratings generally indicate the rating agency’s confidence in the Insurance Company’s ability to satisfy the policy obligations. It is important for RAPs to understand these ratings as they apply to the products being sold and to discuss them with their client(s) accordingly.

Expenses and Fees
It is important for both RAPs and clients to understand all the fees related to variable annuities.

- Contract Fee — an annual fee deducted directly from the annuity assets.
- M&E Risk Fee — an asset-based charge applicable to only the variable sub-accounts. This fee covers standard death benefit costs and the ability to annuitize.
- Administrative Charge — an asset-based charge covering the maintenance of the contract, including record keeping and other administrative expenses.
- Management Fee — an asset-based charge used to pay the portfolio managers of the underlying sub-accounts.
- Premium Tax — A tax imposed by some states applied to contributions made to the annuity.

Contingent Deferred Sales Charge (“CDSC”) and Surrender Schedules—a CDSC is a fee charged for early withdrawals from the contract above the allowed free-withdrawal amount over a given time period. CDSC schedules may range from 0 to 10 years and typically have a declining CDSC schedule (i.e. 7%, 7%, 6%, 5%, 4%, 3%, 2%). CDSC and surrender schedules vary by share class (see the section below titled, “Variable Annuity Share Classes”, as there is generally a cost for liquidity. RAPs should verify that the client understands that higher internal fees may accompany a shorter CDSC period or that there may be lower cost options available in exchange for a greater surrender schedule.

All expenses and fees should be discussed with the client prior to recommending a variable annuity. The Contract Owner should be made aware of any increase in fees and surrender charges/schedules that may occur based upon bonuses or benefits added to the contract.

Variable Annuity Share Classes — B share, L share, C share, Bonus share, and “Bundled” share
Variable annuities offer different share classes which differs in terms of the surrender schedule, CDSC, and fees and expenses. While there are no standard industry-wide definitions of these classes, some of the typical differences are discussed below.

- **B share** — B shares do not have a front-end sales charge at the time of purchase. They impose a CDSC for liquidating the shares prior to the end of the CDSC holding period. The surrender period for B shares is generally 6–8 years. The CDSC normally declines and eventually is eliminated, the longer the policy is held. B shares will generally have the lowest M&E risk fees.

- **“Bundled” share** — Bundled share class products are similar to B share annuities. However, they offer a shorter surrender schedule offer in the form of a buy-down rider. Contract owners can elect to structure a shorter surrender schedule (typically a 4-year) and pay a rider fee. However, once the contract is out of that surrender period, the rider fee drops and the cost reverts back to the original B share pricing.

- **L share** — L shares do not usually have a front-end sales charge at the time of purchase. Like B shares, they impose a CDSC, which applies to a full surrender or partial withdrawals prior to the end of the CDSC surrender period. The surrender period for L shares is generally 3–5 years. The CDSC normally declines and is eventually eliminated the longer the policy is in force. L shares will generally have higher M&E risk fees when compared to B shares. **It is important to note the firm suspended sales of L share products in February 2016.**

- **C share** — C shares typically do not have a surrender schedule and the policy owner has full liquidity of the policy. C shares typically have the higher M&E risk fees compared to B shares, given the increased liquidity.

- **Bonus share** — Bonus share annuities can either be a separate share class or be elected as a rider to B share annuities. Because of the upfront payment enhancement into the policy at contract issue, bonus share annuities can either have increased M&E fees, longer surrender schedules and/or higher surrender charges. Bonus share annuities typically have a 7–10 year surrender period. **It is important to note the firm suspended sales of Bonus share products in March 2017.**

Because the fees and expenses can differ, performance outcomes will also be impacted by the difference in fees and so careful consideration should be given to the client’s investment time horizon.

- **Time Horizon** — An investor’s time horizon is the length of time before an investor plans to withdraw most, if not all, their funds from their account. An investor may also have a different time horizon for a portion of the funds in their account, or a time horizon for specific investments (such as the maturity of a CD).

In the Investment Objective section of the New Account Form, an investor states their intended account level time horizon. When electing a time horizon, investors have one of the following options:

- Under 3 years;
- 3–5 years;
- 6–10 years;
- 11–20 years; or
- Over 20 years.

This election is at the Account Level. The Firm recognizes, however, that within an investor’s account they may own certain investments with various maturity dates and intended holding periods. As such, an investor’s **Account Level Time Horizon** may be different than the intended holding period for different investments or they may intend to withdraw smaller amounts prior to closing the account. An investor’s intended Account Level and investment level Time Horizon may impact the recommendation for variable annuity share classes.

**Annuity Payout Options**

As mentioned earlier, annuitization converts a policy from the accumulation phase the distribution phase. Annuitization payments can be customized to suit personal needs based on the frequency of payments, income amount or guarantee period, and the income option and is one way to guarantee income. Furthermore, for non-qualified annuities, annuitization
offers additional tax benefits. The exclusion ratio treats each annuity payment as a combination of return of principal and investment gain. This spreads out the tax liability as taxes are only assessed on the gain.

There may be a number of ways to receive income payments. Some common annuitized payout options include:

- **Single Lifetime Income**— The Insurance Company guarantees that the Annuitant will receive income payments for the rest of the Annuitant’s life. Payments cease when the Annuitant dies.

- **Period Certain**— The Annuitant will receive income for a set period or time (e.g., 5, 10 or 20 years). If the annuitant dies before the guarantee period is over, the beneficiary will receive the remaining payments. However, all payments stop after the set time period.

- **Lifetime Income with Period Certain**— The Annuitant will receive an income for his or her lifetime. If the Annuitant dies before the guarantee period is over, the Beneficiary will receive the payments remaining per the original guarantee period, also known as a “period certain.”

- **Joint Lifetime Income**— (Usually referred to as “Joint and Survivor.”) Income payments will be received as long as one of two designated people is alive (frequently husband and wife). Upon death of either person, income to the survivor will continue until his or her death. At the death of both people, payments cease unless the option was accompanied by a period certain, in which case the Beneficiary receives payments remaining per the original guarantee period.

There are two types of annuities in the payout period: fixed (in which each payment is a fixed dollar amount) or variable (in which the amount of each payment reflects changes in the market value of underlying sub-account portfolios).

- **Fixed Income Payments** — The Annuitant will receive a fixed dollar amount at regular predetermined intervals. The amount received will depend on the annuitization option elected. The amount of each payment will always be known, but over time this choice may not keep pace with inflation.

- **Variable Income Payments** — Payments will vary based on the performance of the underlying sub-accounts. Income payments may decline in periods of market decline, and increase during periods of market appreciation. Although this option exposes the Annuitant to market risk, it may also protect them during periods of rising inflation.

There are several factors that Insurance Companies use to compute the monthly payment amount. Two of the most common are gender and age; both of which affect life expectancy. Another major factor that affects the size of the monthly payout is the payout option selected, which affects how long the payments will last. For example, for a Joint and Survivor Income option, the monthly payout most likely will be lower as the payment continues to a survivor after the death of either person. Finally, the size of the monthly payout depends on whether a fixed monthly payout or a variable monthly payout option is selected. With the fixed amount, the payout will not change, and the Insurance Company assumes the investment risk. Under the variable payout, the size of the monthly payout fluctuates based on market conditions, so the Annuitant assumes the market risk.

**Types of Variable Annuities**

Over the years, insurance carriers have designed variable annuities that allow a contract owner to take advantage of different types of investment options. These include structured variable annuities and investment only variable annuities:

- **Structured Variable Annuities**
  
  Structured Variable Annuities offer contract holders the ability to participate in equity markets returns that are subject to an upside cap of their maximum return while receiving partial downside protection up to a stated buffered rate. Structured Variable Annuities utilize derivatives to create a desired exposure to large well known indices. The contract owner can allocate their investment in different “segments” that are based on the following:

  - **Index options** — limited equity market participation that mirror the performance of specific indices, such as S&P 500, Dow Jones Industrial Average, Russell 2000, etc.
  
  - **Segment Durations** — Segment durations are the length of time the segment is held (i.e. 1-year, 3-year or 5-year)
Cap Rate — The maximum upside return is subject to an upside cap rate. The Cap Rate varies based on the index, buffer and segment duration. These rates change periodically and are set by the insurance carrier.

Buffered/Downside Protection — The downside protection, or buffer, is the maximum percentage which is protected from market loss over the specified segment duration. Any market loss beyond the buffer will be passed on to the contract value. The Buffered/Downside Protection ranges from 10-100%. It is important to realize that unless there is a 100% buffer, the contract value is still subject to downside risk and a loss of contract value may occur.

B/D Enacted Investment Limitations
Each Structured Variable Annuity is subject to a concentration limit, which is not to exceed 30% of a client’s liquid net worth. This is separate than the alternative investment limitation of 20%.

Additional Training Requirements
All representatives and their supervisors will be required to complete the specific NAIC Structured Variable Annuity Product Training Module prior to the offer and sale of each product. The NAIC training module is required regardless of the representatives and supervisors state affiliation.

Investment Only Variable Annuities
Investment only variable annuities (“IOVA”s) offer a wide array of investment options but typically without any type of living or death benefit guarantees. IOVAs provide the opportunity to allocate amongst unique asset classes on a tax-deferred basis. It is important to note that outside of the ability to annuitize, certain IOVAs do not provide any additional guaranteed benefits to the contract owner. Given a qualified account already has a tax-deferred status, additional consideration should be determined for IOVA’s within qualified accounts (see Other Consideration section below for additional guidance).

Tax Implications
The tax rules that apply to variable annuities can be complicated. Before investing, a tax advisor should be consulted about the tax consequences of purchasing a variable annuity. While there may be other circumstances that impact the tax implications of investing in a variable annuity, some common characteristics of annuities are:

- Annuities grow or earn income on an income tax-deferred basis.
- Taxation of gains, if any, (at ordinary income tax rates) occurs only when money is withdrawn from the contract or when the proceeds from the contract are paid to a Beneficiary.
- Prior to annuitization, the value of the contract is included in the estate of the Contract Owner at death.
- Distributions made prior to age 59½ may be subject to a 10% federal income tax penalty on earnings.
- Annuitization provides tax-advantaged income payouts. In a nonqualified annuity, each annuitized payment represents a combination of two things: earnings and return of principal. Only the earnings portion of an annuitized payment is taxable. This is in contrast to simple withdrawals, which are distributed as earnings first and are therefore 100 percent taxable at ordinary tax rates until earnings are depleted.
- At death, variable annuity values avoid probate.
- At death, proceeds of variable annuities do not receive a “step-up” in cost basis for income tax purposes.

Replacements of Existing Variable Annuity Contracts
A replacement is defined as any transaction where an annuity is exchanged, transferred, or liquidated (full or partial) to fund the purchase of another variable annuity, whether through a 1035 exchange, trustee-to-trustee transfer or a direct rollover.

RAPs should determine that replacing an existing annuity with a new annuity is suitable for the client; considering such factors as product enhancements and improvements (e.g., enhanced death benefits or living benefits), internal fees, including surrender charges and investment options, as well as any features that will be forfeited from the contract being replaced (e.g., loss of death benefits and living benefits).
The RAP should be able to demonstrate for each replacement how the transaction is to the client’s net investment advantage. Any time an annuity is being replaced with another investment, it is imperative to ascertain and document how the change is to the advantage of the client. To effectuate a true side-by-side comparison for an existing and proposed variable annuity, RAPs are required to generate a Morningstar Annuity Intelligence Report as part of the transaction. EOE prompts the RAP to certify to having generated this report. The report is not currently generated or maintained in EOE, so RAPs must maintain a copy of the report in their branch client file. In addition, the Principal may request the report as part of their review process. In cases where the RAP cannot generate the Report because one or more of the variable annuities cannot be found in the Morningstar product selection, the RAP may facilitate a manual side-by-side comparison to illustrate they have considered the key suitability factors, including but not limited to fees and applicable living and death benefits, outlined above prior to making a recommendation. The client must acknowledge and sign the comparison.

Insurance companies often offer bonus annuities as an incentive for exchanges of existing contracts held at other insurance companies. Because bonus annuities provide a premium enhancement upon contract issuance, a client may decide that receiving a bonus in a new contract will mitigate incurring a surrender charge on an existing contract. However, bonuses are often funded through higher costs with the new contract. It is important to inform clients of any increase in internal fees, including M&E risk fees, surrender charge durations and surrender charge percentages in the product being offered upon replacement.

Section 1035 Exchanges
The U.S. Tax Code allows tax-free, Section 1035 exchanges, whereby an existing variable annuity contract may be exchanged for or replaced with a new annuity contract while deferring any tax on the income and investment gains (if any) in the original variable annuity account. 1035 exchanges can be useful if another annuity has preferable features such as death benefit options, living benefit options, different annuity payout options or a wider selection of sub-account investment options. However, a surrender charge on the existing annuity may be incurred and/or a new surrender charge period may begin when the annuity is exchanged. (Please see the Section on Expenses and Fees.)

Partial 1035 Exchanges and Partial Surrenders
The IRS has provided limited guidance on the tax consequences of a partial transfer of an existing annuity contract into a new or existing annuity contract. In Revenue Ruling 2002-75, the IRS approved a tax-free exchange of an entire annuity contract into an existing annuity contract. In Revenue Ruling 2003-76, the IRS approved a tax-free exchange of a portion of an annuity contract into a new annuity contract and indicated that the basis in the two contracts should be allocated pro-rata based on the cash value transferred to the new contract.

In Notice 2003-51, the IRS expressed concern that such partial exchanges could be used to reduce or avoid taxation of distributions under the tax law. The IRS is therefore considering issuing regulations that would presumptively treat withdrawals and surrenders within 24 months of a partial exchange as having been made for tax avoidance purposes.

Pending the publication of the final regulations, the IRS will examine withdrawals from (or surrenders of) either a new or existing annuity contract within 24 months following a partial exchange to determine whether the two contracts should be treated as a single contract. Characterization as a single contract would mean that distributions from either contract would be taxable to the extent of earnings in both contracts. Due to the technical nature of partial 1035 exchanges, the client’s tax advisor should be involved in the decision-making process.

Other Considerations

Variable Annuities in Qualified Accounts
It is important to ensure that clients are aware that purchasing a variable annuity in a tax-qualified retirement account provides no additional tax-deferred treatment of earnings, since the account is already tax deferred. In considering recommendations of variable annuities in qualified accounts, the RAPs must balance the benefit of riders and guarantees with the higher internal fees and expenses in a variable annuity. However, the recommendation of an annuity within a qualified plan may be suitable due to the annuity’s other features, such as the option of annuitizing the contract to receive a guaranteed stream of income, or of purchasing certain guarantees such as living benefits or death benefit protection. The client will also have the option to choose from various investment options that may include fixed accounts. The RAP must clearly explain the benefits and detriments of the recommendation, and supply all required written materials, including the prospectus, to the client.
**Purchases by Older Clients**

It is imperative to understand and to disclose to clients the limits that many annuity products impose on benefits and features for clients above a certain age, which may be as low as 70. For example, a client who is age 70 may be interested in purchasing an annuity because of the death benefit feature. This feature may include a provision stating that, at the Contract Owner’s death, the Beneficiary will never receive less than the Contract Owner paid into the annuity. It may also include a provision that the Beneficiary will receive at least the highest anniversary value of the annuity, even if the Owner dies while the annuity’s value is below this amount.

Frequently, annuity contracts will begin to restrict these benefits, sometimes beginning at age 70. This may mean that if the annuity Contract Owner dies at or beyond age 70, the Beneficiary will receive only the market value of the annuity. In this case, the guarantees that may have been attractive to the client at purchase may no longer be available when needed.

**Summary and Conclusion**

Variable annuities are a viable investment solution for RAPs, and offer clients tax-deferred growth, with investment options and guarantees that are unique. However, variable annuities also generally have higher internal costs to clients, and provide additional compensation to RAPs, as compared to other investment options. Variable products and sales practices regarding these products continue to generate significant regulatory attention, due to the internal costs to clients and the commission structures that provide an inherent conflict for RAPs and firms. As a result, it is important for RAPs to have an understanding of the following factors outlined in this training module:

- Investment objectives and investment time horizon.
- The investment choices offered and their long-term historical performance.
- The reputation of the portfolio managers of the different sub-accounts.
- The financial strength of the Insurance Company.
- How the death benefit is determined.
- The ability to withdraw money during the accumulation period.
- The income payout options offered.
- Total fees and expenses (including withdrawal charges) associated with the variable annuity.

Understanding the basic principles of variable annuities is the first step in making an appropriate recommendation. Variable annuities are complex investments that offer many unique features and benefits. Therefore, it is essential that the RAP and client always read the Prospectus and Statement of Additional Information, which provide specific information regarding the variable annuity structure, sub-accounts, optional riders, and fees and expenses.

**II. Supervisory Procedures**

Rule 2330 requires broker/dealers to fulfill their general obligations to create and maintain supervisory procedures reasonably designed to achieve compliance with the standards set forth in the Rule. The broker/dealer must also: i) implement surveillance procedures to determine if any Associated Persons (“APs”) 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 the Rule, other applicable FINRA Rules, or the federal securities laws (“inappropriate exchanges”); and ii) have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of APs who engage in inappropriate exchanges. To this end, the Firm actively conducts surveillance of variable annuity transactions, in particular those transactions involving 1035 exchanges. RAPs exhibiting inappropriate patterns of 1035 exchange activity will be disciplined, up to, and including, termination. Additionally, Principals who approve such transactions may be subject to disciplinary measures.
III. Training

Rule 2330 requires broker/dealers to develop and document specific training policies or programs reasonably designed to ensure that APs who effect, and Registered Principals who review, transactions in deferred variable annuities comply with the requirements of the Rule and that they understand the material features of deferred variable annuities, including the various suitability obligations of the RAP and Principal. By completing this training module, RAPs are complying with the requirements of this Rule.

IV. Principal Review and Pre-Approval

Rule 2330 requires that, prior to transmitting a customer’s application for a deferred variable annuity to the issuing insurance company for processing, but no later than seven business days after an Office of Supervisory Jurisdiction receives a complete and correct application package, a Registered Principal shall review and determine whether he or she approves of the recommended purchase or exchange of the deferred variable annuity.

A Registered Principal shall approve the recommended transaction only if he or she has determined that there is a reasonable basis to believe that the transaction would be suitable based on the suitability factors provided by the RAP. The determinations documented and signed by the Registered Principal who reviewed and then approved or rejected the transaction. By submitting via the Firm’s EOE workflow, the Principal’s approval or rejection of the transaction is deemed “signature” for the purpose of this Rule.

Aside for the general suitability and red flag items listed above in this module, Principals should also ensure that the VA product selected in EOE (including riders) matches the product application. The Principal should generally review for any inconsistencies relative to data the RAP has supplied on the existing and/or proposed VA.

In an effort to comply with the requirements of Rule 2330, including the timeline provision, the Firm implemented an automated workflow via its EOE platform, outlined as follows:

- Mandatory use of EOE for ALL variable annuity transactions (initial, subsequent and 1035 exchanges).
- For all variable annuity transactions, RAPs MUST input data elements into EOE, including rider and sub-account information.
- For all initial and 1035 exchange variable annuity transactions, RAPs MUST wait for Principal approval in EOE prior to sending the application and/or check or funds to the insurance carrier; or, in cases of rejection, returning any associated check to the client.

Note: For purposes of Rule 2330, the Firm’s only method of evidencing approval shall be EOE only. No other method or approval of hard copy documentation outside of EOE is permitted.

Important Items — Transacting VAs in EOE

The following highlights the primary components of the EOE workflow for RAPs transacting VA business. RAPs seeking more information related to the complete EOE workflow and requirements for VA transactions should visit the EOE section of the Firm’s website for an on-demand training module.

- Submission of VA Transactions
  The VA application must continue to be completed by the RAP and client. We have partnered with an industry vendor to supply data feeds for the most common VA products across our approved insurance carriers. If the product information is available in our system, the RAP merely needs to select the product name at the pre-definition screen. The rider and sub-account information for that product will then be available during the remaining EOE input process.

- Data Field/Paperwork Completion in EOE
  RAPs must ensure each applicable field within EOE is completed accurately. The following are common misconceptions that may result in revision or rejection of transactions submitted within EOE:
    - Referencing “Tax deferral” as the financial benefit when submitting a VA transaction for a qualified account as qualified accounts are inherently tax deferred in nature.
Unless the new product provides a return of premium and/or principal protection, the client should generally be able to tolerate an investment loss.

Ensure your client’s existing assets provided on the order memorandum are consistent with the investment breakdown listed on the client’s current new account form.

Side By Side Comparison via Annuity Intelligence reports
If a RAP is executing a 1035 exchange, or writes a C Share variable annuity, they must complete a side by side comparison in Morningstar Annuity Intelligence listing all applicable benefits on the existing contract and those that are being purchased on the new contract. The comparison must be presented to the client for review and the client must sign and date the report. If a variable annuity (including a structured/buffered annuity) is available within the Morningstar Annuity Intelligence listing, RAPs must complete a side by side comparison.

Surrendering products/Exchanges
Exchanges that incur a surrender charge have additional regulatory scrutiny, therefore these transactions include additional documentation and review. The following are important reminders specific to exchanges:

- Investment Risk Client Acknowledgment – ensure the response is an accurate representation of the exchange given the specific product that is being surrendered.
- RAPs are required to detail the financial benefit of the exchange within the rationale.
- RAPs are reminded that the rationale must be client specific for the transaction submitted.

RAP and Supervisor obligation to understand the features of the product and riders
RAPs and their Supervisors have an ongoing obligation to be aware and knowledgeable of the underlying products that are being presented to their clients. They should not solely rely on the product wholesalers entirely and should review all marketing materials and prospectuses.

Wrong product entered into EOE
RAPs are reminded to be diligent when entering transactions within EOE to ensure the CUSIP, product, sub-account allocation, and product benefits (such as living and/or death benefits) matches the client signed vendor application. Any errors will be subject to be rejected by the Supervisor and will require you to re-enter the entire transactions and obtain new client signed paperwork.

Check Receipt
If the check is in the RAP’s possession at the time of order entry into EOE, the check should be receipted on the “Receipts” tab of the order entry screen.

If a check is provided by the client after submission of the VA order in EOE, the RAP should receipt the check using the “Receipts” tab from the top tool bar located in EOE. The RAP will be required to input the Order # from the corresponding VA transaction. Additionally, the RAP cannot forward the application or check to the insurance carrier until proper Principal approval is received.

Safeguarding of Check
Due to the fact that 2330 VA transactions must be Principal pre-approved prior to submission to the carrier, the SEC has granted an exception to allow the RAP to have receipt of a check during the entire review process. The RAP must enter the check upon receipt, but must also update the receipt once the transaction has been approved or rejected. Accordingly, the Check and Securities Receipt Blotter will reflect a minimum of two entries for each 2330 VA transaction when a check is involved. Existing standards apply related to ensuring the check is properly blottered and secured during the time it is in the possession of the RAP (i.e., locking file cabinet, safe, etc.).

Monitoring of a VA Order
Once a VA transaction is submitted, you may monitor its status via the “VA Order Tracking” queue. This queue will reflect the order, and the number of days the Principal has remaining to approve or reject the transaction. Once approved or rejected, the transaction will move to the “VA Action Items” queue, where the RAP must take further action.

Action if VA Approved
Once approved, you may send the application and check (if applicable) to the insurance carrier. If a check has already been associated with this transaction, please update the existing check receipt, entering the “Ship Date” and “Shipped
To” information. In accordance with SEC regulation, the check and application must be shipped by noon of the next business day following the approval.

- **Action if VA Rejected/Auto-Rejected**
  If a check has already been associated with this transaction, please update the existing check receipt entering the “Ship Date” and “Shipped To” information. In accordance with SEC regulation, the check must be shipped back to the client by noon of the next business day following the rejection. The completed/signed application should be marked VOID or shredded.

  EOE is programmed to auto-reject a transaction at midnight eastern time on the 7th business day. This means that the transaction expired due to the Principal’s failure to approve or reject the transaction within the (7) business days allotted. Unlike a true Principal rejection, auto-reject does not qualify the transaction as unsuitable per se; however, the RAP would need to reinitiate the VA approval process.

### Additional Resources

For RAPs or Principals seeking additional guidance related to Rule 2330, variable annuity features, the Firm’s 2330 EOE workflow, or specific variable annuity product features, please contact the following departments for more guidance:

- **Compliance Department** — General questions related to Rule 2330, variable annuity suitability, and RAP/Principal obligations related to the Rule.
- **Product Department** — General questions related to any specific variable annuity residing on the Firm’s Approved Products list.
- **EOE Liaison** — General questions related to 2330 VA EOE workflow, such as VA order submission, check receipt processing, or monitoring the VA Action Items queue. An on-demand training module related to EOE 2330 transactions is also available from the Firm’s website, under the EOE section.
- **Regulatory Bodies** — Both SEC and FINRA offer a number of resources from their websites, [www.sec.gov](http://www.sec.gov) and [www.finra.org](http://www.finra.org).