

Regulatory brief

January 2015

A publication of PwC's financial services regulatory practice

FINRA 2015 exams: Variable annuities

Overview

The Financial Industry Regulatory Authority (FINRA) recently released its tenth annual Regulatory and Examinations Priorities Letter. As with prior letters, FINRA highlights key areas of focus for regulatory examinations in 2015. However, this year FINRA emphasizes its increased adoption of a risk-based approach for examinations that focuses on high-priority issues.

Accordingly, FINRA has identified variable annuities generally, and “L-Share” annuities specifically, as a significant focal point for exams in 2015, and has pointed out particular elements of sales practices to be scrutinized as part of FINRA examinations this year (including suitability, product knowledge, compensation structure, false representation, first-use communications filing, and training). This focus impacts broker-dealers that are regulated by FINRA, as well as their affiliated insurance companies and banks.

Variable annuities are products with underlying investments that offer consumers a minimum payment at the end of the accumulation period, which is traditionally longer for these products. The amount of this payment depends on the investments' performance. These attributes make some variable annuities inappropriate for investors of particular ages and incomes, such as certain individuals beyond retirement age (due to the long accumulation periods) or those with insufficient liquidity to allow their assets to be locked up. Although these products are often thought of as “insurance” products, they are regulated as securities.

Sales of variable annuities have decreased in recent years, but scrutiny of them has only heightened as issues related to disclosure and sales practices have been identified, and as underlying investments have become more complex. To mitigate the risk of facing FINRA's disciplinary actions and other adverse consequences, it is essential for firms to establish and maintain processes, procedures, and controls around variable annuities. In our view, firms' responses must not be limited to addressing FINRA's areas of focus around variable annuities as enumerated in the 2015 priorities letter; rather, firms should develop a comprehensive overall risk management and compliance program, aligned with FINRA's risk-based supervisory approach.

This **Regulatory brief** analyzes the key elements of variable annuity sales practices that FINRA will scrutinize this year; offers our view of the actions that firms should take in response; and assesses the broader implications of FINRA's risk-based supervisory approach.

Scrutiny of variable annuities

Suitability

Suitability continues to be a significant concern for FINRA, with an emphasis on ensuring that variable annuities are sold via a transparent process to fully informed consumers. To that end, FINRA's existing suitability regulations require transactions to be based on reasonable due diligence by the firm and specifically tailored to customer needs.

We suggest that firms institute a system of supervision focused on initial and continuing suitability training for registered representatives which can be based, in part, on case studies of actual suitability failures. In addition, strong supervision and use of automated controls or manual checklists should be implemented. Firms should also leverage FINRA's suitability guidance (i.e., Regulatory Notices 12-25 and 12-55) to determine whether variable annuity products fit into a client's overall portfolio.

Product knowledge

As a subset of the suitability requirement, registered representatives must perform sufficient due diligence to identify the appropriate product for a particular customer need. The diversity of variable annuity product features requires continuous training and education to ensure registered representatives possess adequate knowledge of products to fulfill this requirement. FINRA has asserted that its examiners will review compliance processes to assess whether they are designed to promote and test satisfactory product knowledge.

To provide registered representatives with adequate knowledge, insurers should implement a product-focused training program that includes on-the-job mentoring and participation in industry trainings, in addition to classroom and virtual training (given the complexity of variable annuities). Training should be provided by knowledgeable individuals that do not focus on the sales of the variable annuities, but rather, on the supervision, compliance, and control aspects of the product.

Compensation and fee structures

FINRA has identified compensation and fee structure as a major contributor to potential conflicts of interest among registered representatives, especially where representatives' incentives are based only on sales goals. Historically, such structures have contributed to predatory sales and marketing practices across the financial services industry, leaving FINRA with concern.

In order to be prepared for potential FINRA examinations, firms should internally review variable annuities' compensation and fee arrangements to identify any actual or perceived conflicts of interest. Compensation arrangements should be structured to align with, and not compete against, compliance requirements. Where potential conflicts of interest are detected, firms should document how the conflicts are eliminated, mitigated, or disclosed. Firms should also question whether registered representatives are incented to sell variable annuities with higher fees and commissions.

False or misleading representation

As in prior years, FINRA will continue to review registered representatives' sales practices of variable annuities to identify individuals and organizations that intentionally provide false or misleading information to customers, and will take disciplinary action on any willful violations.

Firms can mitigate the risk of disciplinary action by establishing a system to properly train registered representatives on key features of variable annuity products and on proper procedures for sales and marketing communications. The system's effectiveness should be monitored through registered representative interviews, file reviews, and customer complaint reviews to confirm procedures are followed. In addition, appropriate oversight and transaction review should be implemented or enhanced, and registered representatives' electronic communications and use of social media should be reviewed.

Disclosure adequacy

Broker-dealers are required by multiple regulatory bodies to provide customers with adequate disclosure of variable annuity fees, terms, and material features. FINRA's specific mention of such disclosures in its 2015 priorities letter indicates its focus on evaluating such disclosures for potential noncompliance during its examination process.

In our view, firms should implement automated controls or manual checklists to alert registered representatives when disclosures must be provided. Additional training may be considered for this process to ensure registered representatives and their supervisors understand product-specific disclosure requirements and timing of disclosures.

First-use communications filing

As identified in FINRA Rules 2210(c) and 2220(c), certain types of retail communications must be filed with FINRA's Advertising Regulation Department within 10 days of, and in some cases prior to, first public use. FINRA's specific identification of the 10-day filing requirements within their 2015 priorities letter may indicate increased scrutiny around these provisions in the coming year.

To prepare for potential FINRA examinations, firms should establish a central process to review and file retail communications to enable consistency and simplification of the supervisory process. In addition, firms may launch an advertising and communication awareness campaign providing guidance on the different types of communications, when reviews may be required, and who should perform the review.

Training

As noted in several areas above, training is a vital element of compliance with FINRA's requirements and expectations around variable annuity sales. FINRA will continue to examine training processes, supervision, and compliance reviews to ensure that appropriate training has been administered and adhered to among both registered representatives and supervisory employees.

Accordingly, firms should establish broad-based training programs for the sales force and their supervisors on policies related to variable annuity sales suitability, communications with the public, and disclosures. Additional training should be provided on product-specific features and requirements. We also recommend that firms evaluate alternatives to traditional training platforms that may be better suited to their needs, such as email, blog posts, newsletters, mentoring, on-the-job shadowing, and industry seminars and conferences.

"L-Share" variable annuities

Among variable annuity products, FINRA has identified "L-Share" annuities as a particular focus for review and examination. "L-Share" annuities typically have shorter surrender periods and higher fees, and while appropriate for some customers, can be marketed to customers for whom they may not be suitable. In 2015, FINRA will likely pay particular attention to multiple aspects of compliance regarding these products' sales and marketing, including suitability, compensation and fee structures, registered representatives' knowledge of the products, and customer disclosure adequacy.

In order to prepare for increased regulatory scrutiny, firms should implement a rigorous training program for "L-Share" annuity products including a focus on related fees. This program should provide training for both registered representatives and their supervisors, and should evaluate whether these products necessitate any changes to the overall suitability program given their differences from other variable annuity products. To further mitigate compliance risk, firms should consider requiring principal signoff on all "L-share" purchases, and may consider prescribing age and liquid net worth requirements to purchase "L-shares." Finally, as noted above, incentives for selling "L-Share" annuities should be reviewed.

Broader implications: A risk-based approach

Beyond variable annuities, it is important to note the broader focus of FINRA, especially on higher risk organizations and activities. FINRA expects organizations to develop comprehensive overall risk management and compliance programs, which we believe at a minimum, should include:

- An overall governance structure and tone-at-the-top that shows commitment to a compliance-focused culture and ethical practices.
- Documented policies and procedures that are acknowledged by employees to whom they apply, and updated on a continual basis to reflect the changing regulatory environment and evolving customer needs.
- Effective controls designed to enable a right-sized approach to supervision given the identified risks.
- Clearly defined roles and responsibilities for registered representatives, their supervisors, and compliance personnel.
- Clearly defined conflicts of interest policies, procedures, and processes, including how actual and perceived conflicts are reviewed, disclosed, and resolved.

Additional information

For additional information about this Regulatory Brief or PwC's Financial Services Regulatory Practice, please contact:

Dan Ryan

Financial Services Advisory Leader
646 471 8488
daniel.ryan@us.pwc.com

David Sapin

Partner, Financial Services Regulatory Advisory
646 471 8481
david.sapin@us.pwc.com

Armen Meyer

Director of Regulatory Strategy
646 531 4519
armen.meyer@us.pwc.com

Chris Joline

Partner, Financial Services Regulatory Advisory
646 471 5659
chris.joline@us.pwc.com

Grace Vogel

Senior Strategy & Policy Advisor
646 313 0024
grace.b.vogel@us.pwc.com

Contributors: Mike Bernardo, Melissa Card, and Kristen Gaebel.

To learn more about financial services regulation from your iPad or iPhone, click here to download PwC's new Regulatory Navigator App from the Apple App Store.

Follow us on Twitter @PwC_US_FinSrvcs