



Broker-Dealer
Investment Adviser
Insurance
Research

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What's Next for Firms Manufacturing or Distributing EIAs?

By Larry Niland, LIMRA Senior Regulatory Advisor

*Rule 151A is scheduled to take effect January 12, 2011**

The majority of EIA issuers are not registered as securities firms under the Securities Exchange Act of 1934 ("Exchange Act"). Instead they sell their EIAs through independent agents who are usually wholesalers, IMOs, or MGAs; the selling representative is, in most cases, not a registered representative of either the selling firm or any other firm. Some representatives selling EIAs today may be the registered representatives of other broker-dealers, selling them as outside business activities (OBAs). However, once these are deemed to be securities then those representatives will have to offer them under a selling agreement through their firm or be in violation of securities laws (i.e., selling away).

SEC filings required by EIA issuers

Firms offering EIAs may not have to comply with the fullest extent of SEC rules (e.g., 10K, 10Q, and 8K filings) covering securities issuers, but they will still have to file Form S-1. The SEC indicates that these EIA issuers, to the extent they are regulated by the states, will be exempted from the transactional-level filings since there are not necessarily any securities transactions in a product that is tied to an index.

The SEC has proposed new Rule 12h-7** that would provide an insurance company with an exemption from Exchange Act reporting with respect to indexed annuities and certain other securities issued by the company if they are registered under the Securities Act of 1933 ("Securities Act") and regulated as insurance under state law. As a result of proposed Rule 12h-7, insurance companies would not be required to file Exchange Act reports on these forms in connection with indexed annuities that are registered under the Securities Act.

The SEC also believes that proposed Rule 151A would decrease the existing disclosure burden for Form S-1. This is because the disclosure burden for each indexed annuity on Form S-1 is likely to be lower than the existing burden per respondent on Form S-1. Those fixed annuities issued with market value adjustment features are also addressed by the rule and the SEC observes that most of these are already offered as securities. Therefore, the SEC believes that no additional burden will be imposed.

*The effective date of §230.151A is January 12, 2011.

**The effective date of §240.12h-7 is May 1, 2009.

NOTABLE

- ▶ LIMRA introduces a new online supervisory controls system
- ▶ Fred McDonald, former FINRA Director of District 11, joins LIMRA as our newest consultant

COMING SOON

- ▶ Podcast:
March 2009
Rule 8210 vs. Privilege
- ▶ Webinar:
March 25, 2009, 2 pm EST
The Efficient Compliance Department

SERVICES AND PRODUCTS

- ▶ 3012 Consulting
- ▶ AML Education
- ▶ AML Auditing
- ▶ Branch Auditing
- ▶ Seminar Auditing
- ▶ Post-Sale Suitability Surveys
- ▶ WSP Manuals
- ▶ RIA Consulting and Auditing
- ▶ . . . and more

CONTACT US

For information, assistance, or proposals:

LIMRA Compliance and Regulatory Services
300 Day Hill Road, Windsor, CT 06095
Phone: 877-843-2641
Email: Compliance-RegSvs@limra.com

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Distribution issues

For EIA issuers, distribution issues are the primary obstacle in this new world and are second only to the issuer requirements to comply with the SEC registration requirements under the Securities Act. The primary issues for manufacturers are:

1. Distribution of EIAs, since most current distribution is through non-registered representatives and now all EIAs must be sold through a broker-dealer by a registered representative.
2. Unless those firms that decide to stay in this product space are able to successfully align with a broker-dealer capable of producing consistent sales volume, or form their own broker-dealer, they will be facing a serious deterioration in sales volume.
3. Due diligence requirements for broker-dealers will generally tend to produce a finite limit on the number of selling agreements that broker-dealers will feel comfortable in executing, thereby limiting the sheer number of product offerings. For more information see NASD NTM 05-26: <http://www.finra.org/web/groups/Industry/@ip/@reg/@notice/documents/Notices/P013755.pdf>.

Most broker-dealers will tend to limit the number of offerings due to the expenses and resources associated with: completing due diligence, ongoing review of company activities and sales materials, executing selling agreements, and allowing access to selling representatives. It is worth noting that there was not a significant volume of EIAs sold as private securities transactions under Rule 3040 through broker-dealers following the guidance of FINRA. Most firms elected to treat EIA sales as OBAs under Rule 3030. For more information see NASD NTM 05-50: <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p014821.pdf>.

Major issues and decisions

EIA firms that decide to continue issuing EIAs under the new rule have some major issues to consider and decisions to make:

1. Register with the SEC.
2. Register key marketing and sales staff with FINRA for those activities dealing with distributors and/or the public.
3. Redesign advertising and sales materials to comply with FINRA rules and regulations.
4. Evaluate marketing strategies and how they compensate selling firms and other intermediaries in order to comply with FINRA cash/non-cash compensation rules.
5. Evaluate issue, billing, and customer reporting systems to comply with FINRA and SEC guidelines on payment transaction reporting and disclosures.
6. Consider if the firm will be able to make its return on equity goals taking into account these additional burdens.

Investor Fraud With a 'New' Twist

By Paul King and Mary Harris, LIMRA Consultants

Recent press coverage of the Madoff Investment Securities scandal has heightened awareness of Ponzi schemes. New allegations of similar schemes are making the news with alarming frequency, as the money involved disappears and defrauded investors start asking questions. Ponzi schemes often flourish when the investment climate is promising and when they maintain the ability to pay unwitting investors on time and as promised. In a depressed market, cash inflows dry up, and payments to "investors" shrink or disappear altogether.

Unfortunately, as investors clamor for their funds in these failed schemes, con artists often take another shot at victims' money through what is dubbed a "reload." The Ponzi operators promise their panicked investors that they have a new and better plan and they try to convince their victims to contribute even more money.

A disturbing twist involves con artists persuading victims — who often believe they are part of an "investment club" — to open trading accounts in their own name, and subsequently grant the con artist full power of attorney (POA). As designated POA on victims' accounts, the scammer now has authority to trade in and withdraw funds from victims' accounts.

Quick Tips

- ▶ Run system reports to identify accounts where POAs have been granted and look for a common person or entity that has been granted these powers.
- ▶ Be alert to "investment club" accounts since this may be the con artist's income source.
- ▶ Consider performing CIP on those granted POA; regulatory changes may mandate this in the future.
- ▶ Producers and staff should be alert while interacting with clients and prospects for similar red flags, including clients who mention participation in an "investment club." Encourage them to inform compliance, AML, and legal staff.
- ▶ The same issues can occur with insurance products. If money can be moved, there are those who will try to do just that.
- ▶ Report suspicions to industry regulators and law enforcement.

Social Networking Sites and Broker-Dealer Compliance

By Stephen Selby, LIMRA Regulatory Services Director
and Donna Stalley, LIMRA Associate Research Director

A recent survey of 22 insurance company affiliated broker-dealers found that five firms permit the use of social networking sites, with restrictions. Restrictions include: requirements for prior approval, editing to brand standards, and requiring appropriate disclosures on profiles.

When developing policies and procedures concerning social networking, firms should consider the following:

- Because social networking sites are viewable anywhere via the Web, compliance departments need to ensure that producers don't inadvertently solicit beyond states in which they are licensed and/or registered.
- [LinkedIn.com](#) allows recommendations by one user about another user. If the producer is an IAR then such recommendations are potentially prohibited "testimonials" pursuant to SEC Rule 206(4)-1 (Advertisements by Investment Advisers).

- The firm will need to carefully weigh rules of all applicable jurisdictions and develop a robust supervisory program.
- Firms need to decide how to evidence supervision to regulators. If a firm decides to prohibit the use of social networking sites then how will the prohibition be supervised and evidenced?

Quick Tips

- ▶ Require producers to include compliance staff as "contacts" or friends.
- ▶ Review producer status updates regularly.
- ▶ Update the firm's compliance manual and communicate regularly with producers.
- ▶ Restrict producers' contact lists to clients living in states where the producer is licensed and/or registered.
- ▶ During audits, check the producers' contact lists against client files.

A Checkup for Your Product Development Checklist

By Larry Niland, LIMRA Senior Regulatory Advisor

FINRA has provided guidance in NASD NTM 05-26 with respect to best practices for broker-dealers when reviewing new products. When evaluating new product approvals it can be helpful to ask one question with regard to any product: "What might a complaint look like in five or ten years on this product?"

With question in mind, I have proposed the following nine questions that I extracted from NTM 05-26: <http://www.finra.org/web/groups/Industry/@ip/@reg/@notice/documents/Notices/P013755.pdf>.

I have suggested appropriate company responses to each issue, based on the inherent risk and potential liability associated with any new product offering.

Q1: Is the product new to the marketplace or the firm?

A1: Firms must provide training to representatives who are not familiar with the new product and how it aligns with the needs of the marketplace. If the features are so new that prospects may be unfamiliar with the concept or terminology then client-facing materials must be reviewed for clarity and ease of understanding.

Q2: Will the product be offered by representatives who have not previously sold the product?

A2: Specific product training for representatives may need to be supplemented with generic training on alternative recommendations to clients. In those cases where both representatives and clients are unfamiliar with the product or its alternatives, companies should pay heightened attention to point-of-sale materials and clarity of the disclosures regarding risks, charges, and fees.

Q3: Does the product involve material modifications to an existing product, including any change in risks passed on to the customer, product structure, or fees and charges?

A3: Any product similar to one previously sold with different features, structure, or charges poses a risk if such changes go unnoticed and/or are not clearly disclosed. Training should emphasize the changes, and sales presentations and materials should prominently disclose any new features or charges.

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Q4: Does the product require material operational or system changes?

A4: If heightened or additional review, such as principal review, is required for the sale of certain products or for sales to certain markets (e.g., seniors) then firms must have written procedures in place to conduct the review, including what criteria will be used during the review before the product is first offered for sale.

Q5: Is the product an existing product that is being offered to new markets, a new geographic region, or to a new type of customer?

A5: Companies must provide training to representatives who are unfamiliar with the new product or how it aligns with the needs of new markets. If the features are new to the marketplace and the prospects are unfamiliar with the concept or terminology then all materials that clients may see should be reviewed for clarity and ease of understanding.

Q6: Is the firm proposing to sell a product to retail investors that it has previously only sold to institutional investors?

A6: Retail investors may be unfamiliar with the concepts or terminology used with institutional, sophisticated, or accredited investors. Similarly, the standards used for determining suitability can be higher for retail buyers than for institutional or sophisticated buyers. It is rare that a product suitable for institutional investors is also generally suitable for retail investors.

Q7: Would the product involve a new or significant change in firm procedures, sales practices, or an amendment to the firm's Form BD?

A7: Any product that causes a firm to amend or change its member agreement (CMA) under Rule 1017 will usually require the firm to also amend its written supervisory procedures. FINRA may request a copy of those WSPs prior to approving the CMA. Firms should also identify any needed changes to the firm's supervisory structure, principal and representative registrations, disclosure forms, firm element, and 3012 testing procedures. The local FINRA district liaison, while they cannot provide approval for the CMA, may help your firm navigate this process.

Q8: Does the product raise conflicts that have not previously been identified and addressed?

A8: Any new conflict of interest arising from a new product offering must be addressed. Conflicts undermine investor trust and confidence and must be either resolved or clearly identified, disclosed, and well documented. Firms must remedy any conflict that disadvantages one client or group of clients over another.

Q9: Will the firm seek revenue sharing to offset the cost of distribution and how will that be disclosed?

A9: One of the more challenging aspects of new product approval can be the compensation and how it should be disclosed. Transparency of compensation is an increasing trend and it continues to gain favor with regulators. Firms should be mindful of all aspects of distribution — who gets paid for what, and how that may impact what ultimately gets sold. Firms should disclose compensation details when in doubt.

Don't Forget About Form 13F!

By Paul King and Mary Harris, LIMRA Consultants

Right about now it may feel as if it's the reporting period for just about everything — budgets, examination cycles, annual audits, regulatory filings, etc. Whether or not your fiscal and calendar years coincide, it may also be an opportune time to determine if the firm needs to file Form 13F.

The SEC requires *institutional investment managers* to report holdings if they exercise investment discretion in "Section 13(f) securities" of \$100 million or more. The "Official List of Section 13(f) Securities" can be found on the SEC's Web site for both current and archived data. Section 13(f) securities typically include exchange and NNMS equity securities, certain equity options and warrants, some convertible debt, and closed-end investment company shares.

An *institutional investment manager* is an investment adviser, broker/dealer, pension fund, insurance company, trust department, or corporation that invests in securities for its own account — or a person or entity that exercises investment discretion over the account of any other person or entity. It is likely that you fall into one or more of these categories.

Quick Tips

- ▶ Run reports to identify discretionary and/or proprietary accounts. Total these for assets under management. Do they surpass the threshold?
- ▶ Review the quarterly pdf report titled "Official List of Section 13(f) Securities" found at <http://www.sec.gov/divisions/investment/13flists.htm> to determine reportable securities.
- ▶ Review the SEC's Division of Investment Management Web site under "Frequently Asked Questions About Form 13F"
- ▶ Consider reviewing other firms' Section 13(f) filings via the SEC Edgar database: <http://www.sec.gov/edgar/searchedgar/webusers.htm>.
- ▶ Search under "Companies & Other Filers" under "General Purpose Searches." Enter "13(f)" in the "Form Type" field in the "Latest Filings" search function.