

October 2010

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This complimentary newsletter addresses current regulatory concerns around the world and provides broker-dealers, investment advisers, and insurance companies with tips and suggestions for meeting regulatory obligations.



## United States

# How the NAIC Model Act Is Changing the Way Annuities Are Sold and Supervised

The NAIC Model Act (Suitability in Annuity Transactions) is gaining wide adoption, and is changing the way all annuities — fixed and variable — are designed, distributed, and supervised. The Act removes some of the protections previously in place for issuers where responsibility for the suitability and supervision of the sales transactions could be delegated through selling agreements to the selling firm, producer, or other intermediaries. When adopted in its model form, the Act places new obligations squarely on the insurance company issuing the contract to implement new procedures, controls, exception reporting, training, and pre- and post-issue review processes surrounding annuity sales and replacement sales. How will this impact the companies that issue annuities? The reality is that very few departments — from product development to new policy issue — will escape having to make changes in the way they conduct business. This article outlines some of the changes that specific departments inside issuing and selling firms should consider as the Act becomes law over the coming months.

### *Product Development*

As new annuity products and features are developed and introduced the product design team must weigh how these products or features meet specific client needs, and under what circumstances they might not be suitable for other clients. This means that the product development team must work closely with training, new policy issue, and compliance to make sure everyone who either trains producers, produces sales materials, or reviews new applications understands exactly for which clients the new product or feature is suitable, and why.

The Act also presents a significant hurdle for new product rollout in that it specifically requires all producers, regardless of distribution channel, to be trained on how the consumer would benefit from certain features of the annuity, and how the particular annuity and riders of each company are suitable for the particular consumer based on his or her circumstances. In other words, no producer can solicit or sell your new product until the annuity carrier certifies that the producer

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To suggest article topics or request article reprints:

Stephen Selby

[sselby@limra.com](mailto:sselby@limra.com)

<http://www.linkedin.com/in/stephenselby>

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For more information about LIMRA's services:

**LIMRA Compliance and Regulatory Services**

300 Day Hill Road, Windsor, CT 06095

Phone: 877-843-2641

Email: [Compliance-RegSvs@limra.com](mailto:Compliance-RegSvs@limra.com)

Web site: [www.limra.com/compliance](http://www.limra.com/compliance)

## How the NAIC Model Act Is Changing the Way Annuities Are Sold and Supervised

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has been trained on the specific features and benefits of the new product. Previously, once a new policy form was approved by the state, wholesalers needed only to provide new sales materials and product descriptions to producers, who could then immediately begin to sell it. Now, producer training content, delivery, and certification must precede any sales of a new product or feature.

As a result, selling firms will be looking to the insurance carriers to make product-specific training available to principals, representatives, and producers in order to carry out their training and suitability review obligations. While manufacturers are permitted the "safe harbor" of considering that sales made by FINRA firms and their representatives are in compliance with the Act, they can only do so if they provide those firms with the necessary tools to effectively monitor and carry out their supervisory obligations.

### Product Training and Marketing

Insurance carrier producer training departments and marketing departments will need to quickly adjust to the new requirements. Training departments at career firms likely will be heavily involved in producer training. Marketing departments will need to redraft marketing materials to include which product features are suitable or not, and for which prospects and why. Just calling the existing product marketing materials "training" will not be acceptable. Those training materials will need to be modified and enhanced. Any marketing approaches, sales concepts, or techniques will need to be removed — and new content will need to address how the consumer would benefit from certain features of the annuity, based on his or her suitability information.

This also puts a new twist on training materials. In the past, sales and training materials could describe the product's features and benefits and outline possible sales approaches and concepts. As long as this was done in a balanced manner, equally presenting the risks and the benefits, the requirement was met. The Act now introduces two new concepts in its language. First, that training should address how the specific product and features of the annuity will benefit a specific consumer; and second, that the transaction, including replacements, "as a whole" is suitable for that consumer, in light of the facts and circumstances. These new concepts make a case for training producers not just on when and where the product, its particular features, or the whole transaction might be suitable; but also on when they might *not* be suitable. This type of training would also be valuable for home office and distribution partner reviewers or principals.

Training staff could also sit in on the product development process, to learn early on about the product's features so that training can be ready on "day one." This would also provide them with an opportunity to provide input to the product development team on any particular training challenges that a complex product feature or rider might present.

Training delivery and certification are perhaps the biggest challenges that the Act presents. As with many new state risk-based education requirements such as training on sales to elderly consumers, sales are not permitted with a simple licensed producer appointment any longer. Many states require (and the Act is no different) that specific additional “CE” producer training be certified as delivered before a policy can be solicited or issued. The Act requires two specific training requirements. First is the basic training by a state-approved vendor or other provider, on annuity suitability as defined under the Act. Second — and perhaps more challenging — is the requirement that each carrier certify that their producers have been trained on the specific features and benefits of the products. This requirement effectively joins product development and producer training “at the hip” going forward. Every new product innovation now must be preceded by a training module, and manufacturers must be able to certify delivery to the producers before the first sale.

### ***Compliance and Audit***

It is expected that future state market conduct examinations will review all aspects of an annuity company’s compliance with the Act, as they may already do where the Act is currently effective. The compliance and audit teams have several new areas to test, and some will be areas in which they had little previous involvement. As noted earlier, FINRA selling firms can be relied upon to carry out the suitability review under the Act, and those sales will be deemed to be in compliance with the Act as it closely mirrors the requirements of 2821 (now 2330). However, in order for an annuity company to rely on that they must:

1. Monitor the FINRA member broker-dealer, using information collected in the normal course of an insurer’s business; and
2. Provide the FINRA member broker-dealer with information and reports that are reasonably appropriate, to assist the FINRA member broker-dealer to maintain its supervision system.

This then directly obligates the annuity carrier to monitor and produce exception reports to a distributor. Reports should test and detect transactions outside the expected norms, using information collected in the ordinary course of reviewing new applications, and other data such as customer surveys. In addition, the information in those reports should be provided to the selling firm. Selling firms may also request that the issuing carrier give them the additional information they feel they need to effectively carry out their duties, and may request that the carrier conduct post-issue customer surveys and report

unusual responses or transactions such as excessive or undisclosed replacements. These reports can help firms compare their sales activities with those of other firms or the market as a whole.

Compliance testing should be done on how the firm is meeting the training requirement, testing the new issue licensing and training cross check. Does training adequately inform the suitability choices? Is the suitability review process in new issue adequate to the regulation? Who is doing the review? Are they trained and qualified? How are questionable cases escalated for added review? What issue systems reports showing suitability data are produced? Could they show, for example, how many clients over a certain age are buying annuities with a certain rider? Who is looking at these reports? Are there reports that show trending, or how many replacements are being handled? What about undisclosed replacements? Have any selling firms requested any special reports? Would it make sense to provide similar reports to all selling firms? Training tests should cover both the basic and the product-specific components: whether new product features an riders are properly delivered before new product sales; how well the product-specific training addresses whether or not the new feature or rider is suitable for certain clients; and if the internal review staff are appropriately trained on how to review applications for the new feature or benefit.

### ***Complaints and Customer Service Areas***

The Act will also raises new questions about customer service. What is being done differently in how the firm handles complaints? Are changes to complaint handling being considered in response to the Act? Has the method for reviewing and settling complaints been modified to conform to the expectations of suitability under the Act? Are complaints that were previously sent to selling firms now reviewed in house? Who is tracking trends on those complaints?

### ***Insurer’s New Policy Issue Department***

Most new issue systems have a cross-check limiting policy issue unless the producer is properly licensed. The Act adds another layer to the producer license check, as systems will need to check for completed training prior to issue, similar to AML. Most firms have a basic license check, but just being life and annuity licensed is not sufficient. Producers must show that they have both the basic annuity training and the carrier’s product-specific training on the features and benefits and the suitability of each, or policy issue should not proceed. Product-specific cross checks will need to be added to compare the product

applied for and all its riders to the training the producer has completed. Any system doing the training verification must be able to certify to each policy form and rider.

Although the Act does not impose any specific license or training requirement on firm new business review staff, this is implied in the obligations placed on the insurance company. Reviewers should be trained on all of the same content as the producers, plus be well informed of all the various features of the annuities sold by the firm and how to spot “red flags” such as the imposition of new surrender period within a few years of a similar surrender; indications the consumer may not be aware of the new surrender charge; or potential tax penalties, higher mortality and expense fees, or loss of any death or living benefit. Reviewers should be able to discern that the particular annuity as a whole, the underlying sub-accounts to which funds are allocated at the time of purchase or exchange of the annuity, and riders and similar product enhancements, if any, are suitable (and in the case of an exchange or replacement, the transaction as a whole is suitable) for the particular consumer based on his or her suitability information, and how to escalate questionable case to supervisors for added review.

*By Larry Niland, Senior Regulatory Consultant, LIMRA, and former CCO of the John Hancock Financial Network. Please contact Larry at 877-843-2641 or [lniland@limra.com](mailto:lniland@limra.com) if you have any questions about this article.*

## How LIMRA Can Help

LIMRA has the expertise and the resources available to help your firm achieve full compliance with the NAIC Model Act. We are a leading provider of

- Basic suitability training
- Product-specific training customized for your specific needs
- Customer suitability outreach and data management solutions
- Meetings and member committees where experts and industry peers review and share best practices

## Suspicious Activity Reports: The Essence of AML Programs

A cornerstone of the Bank Secrecy Act (BSA) is the criminalization of money laundering and the requirement that financial institutions report suspicious transactions to law enforcement. Suspicious Activity Reports (SARs) help law enforcement to identify, investigate, and prosecute persons for money laundering and other crimes for profit.

SAR filing is critical in preventing the legitimate U.S. financial system from being used for money laundering and other illegal activities. And yet, financial institutions continue to be the subject of Cease and Desist Orders and Deferred Prosecution Agreements for failing to file these required reports. Why?

This article identifies causes for failing to file SARs, and offers recommendations for addressing the causes.

### *Observing the Rule — But not the Principle*

BSA regulations are rule-based. For example, regulations list the required elements of an anti-money laundering (AML) program as:

1. An AML compliance officer responsible for day-to-day adherence to BSA requirements
2. Continuous BSA/AML training for relevant employees
3. Periodic independent testing of AML programs
4. Policies, procedures, and controls

Adherence to BSA rules does not protect financial institutions that fail to prevent money laundering from occurring and recurring within their company. The core purpose of the BSA is to prevent criminals from laundering their proceeds through financial institutions. Prosecutor investigations of financial crimes generate criminal subpoenas that are served on financial institutions. Records obtained from criminal subpoenas frequently identify failures of financial institutions to file SARs on significant numbers of transactions. Once this happens, the financial institutions are subject to formal actions by prosecutors for failing to file SARs.

### **Recommendation**

Observe the rules, but also emphasize the principle of not allowing money laundering to occur within your company. Include a concise statement in the company’s Board-level AML Policy, “it is our policy to not allow the company to be used to launder money.” Emphasize the principle of not allowing the company to be used to launder money in all ongoing BSA/AML training. To support the principle, training should provide detailed examples of money laundering schemes, current trends, and financial crimes relevant to the company’s actual money laundering risks.

### *BSA/AML Risk Assessments*

Another reason for failing to file SARs may lie in the financial institution’s BSA/AML risk assessment. While a BSA/AML risk assessment is not a listed AML requirement, it is a regulatory expectation. Financial institutions are expected to apply a risk-based approach to mitigating their risks of money laundering. Therefore, a

risk assessment is necessary in order to tailor the financial institution's AML program to their specific money laundering exposure.

Regulatory guidance for constructing risk assessments focuses on *potential* money laundering risks related to their customer base (e.g., politically exposed persons), product and service offerings (e.g., correspondent accounts), geographic risks (e.g., non-cooperative countries and territories), and client interface (e.g., Internet only).

### **Recommendation**

Money laundering requires a financial transaction. Accordingly, financial institutions' risk assessments should focus on identifying transactions that represent a high risk for money laundering. Mitigating the company's actual transactions that represent high risks for money laundering aligns financial institutions' AML programs with the SAR filing expectations of the BSA. That expectation is to report any suspicious transaction relevant to "a possible violation of law or regulation."

### **Organizational Structure**

The organizational structure of financial institutions can also contribute to SAR filing failures. Organizational structures that permit more than one function to file SARs create challenges for SAR filing. These challenges include variances in the quality of investigations of unusual transactions, inconsistent decision-making regarding the basis for filing a SAR, and quality control issues within the SAR itself. BSA regulators download SARs from the FinCEN database and conduct a detailed analysis of individual SARs and filing trends prior to their examinations.

### **Recommendation**

Enterprise-wide organizational structures should include a centralized function for filing SARs. Centralization allows employees with specialized BSA/AML skills to investigate and make defensible SAR filing decisions. Centralization facilitates all relevant information within the firm to be streamed to the SAR filing function. Centralization of the SAR filing function allows the AML compliance person to provide meaningful oversight of this critical function.

### **Electronic Data Management**

For all but the smallest companies, analyzing unusual or suspicious transactions requires an electronic case management system. Employee referrals and results of electronic transaction monitoring need to be captured and collated in order to identify patterns and relationships. Electronic case management systems need to provide for a

progression from triage, to investigation, to making a SAR filing or no filing decision. The system must be capable of documenting the basis for decision making and identify the information supporting the decision.

### **Staffing**

A growing concern for regulators is that employees assigned to BSA/AML functions lack sufficient BSA/AML expertise. To meet regulatory expectations employees must have the requisite knowledge, skills, and abilities to reliably distinguish between financial transactions and events that require a SAR filing and those that do not. Too often individuals who are assigned to make these judgments are relatively low-level employees without authority or knowledge of money laundering, financial crimes, or law enforcement protocols.

### **Recommendations**

Companies need individuals with BSA/AML expertise to reliably identify and investigate transactions that might require a SAR filing. The AML compliance officer is expected to oversee day-to-day compliance with the BSA and have sufficient authority within the financial institution to assure compliance. Where trends are identified appropriate responses need to be initiated. Those responses include:

- Revision of the affected risk assessment and heightened monitoring
- Enhanced controls
- Termination of client relationships, *or*
- Amending the financial institution's business plan.

Decisions to terminate client relationships or alter the financial institution's business plan obviously involve senior management. At this point, the tone at the top is essential to AML compliance. The harsh reality is that money laundering often provides a profitable revenue stream to the company. The true cost of laundering money is only incurred upon discovery by regulators or prosecutors. Regulators can levy Cease & Desist Orders that include fines, and remediation costs that frequently amount to several times the amount of fines. Prosecutors can also impose fines, deferred prosecution agreements, and criminal charges against both individuals and the company. Prosecution of a company under criminal money laundering charges can result in the corporate "death penalty" as a result of the company's loss of its license to do business. AML compliance officers must be capable of providing senior management with a strong and persuasive business case for recommending the termination of significant client relationships or changes to business plans based solely upon money laundering risks.

## **Training**

There is a growing concern that BSA/AML training is not sufficiently targeted to job functions. Training tends to be generic and does not enable employees to identify transactions or attempted transactions that should be unusual or suspicious.

## **Recommendations**

BSA/AML training can contribute significantly to reducing the risk of failing to file SARs. Training should be tailored to position descriptions, and should emphasize employees' opportunities to observe transactions that represent money laundering risks. Provide examples of transactions they should consider to be "unusual" or "suspicious." Specific activities listed on the FinCEN Form 108 "Suspicious Activity Report by Insurance Companies" can provide appropriate generic examples of the types of financial transactions that might need SAR filings. Training should emphasize the financial institution's requirement to file SARs. This message should be reinforced by a statement from senior management. The consequences for failing to file SARs should be articulated as they relate to employees, their supervisors, the financial institution, and the U.S. financial system.

## **FinCEN Guidance on SARs**

The designated AML compliance person should monitor FinCEN guidance on SARs, for their industry, as well as other industries. Current FinCEN publications for the insurance industry include: [\*Insurance Industry Suspicious Activity Reporting: An Assessment of Suspicious Activity Report Filings \(April 2008\)\*](#); and [\*Insurance Industry Suspicious Activity Reporting — An Assessment of the Second Year of Suspicious Activity Report Filings \(January 2010\)\*](#).

The 2010 report covers the period beginning May 2, 2007 through April 30, 2008 and includes some preliminary observations through October 2009. While the report states that voluntary SAR filing for the insurance industry's second year of mandatory reporting nearly doubled from 641 to 1,276 SARs, during a comparable one-year period depository institutions filed 651,183 SARs. A more alarming number is that half of the SARs filed by the entire insurance industry for the year came from only two companies. Because FinCEN reports are public record, criminals and professional money launderers also have access to them. A professional money launderer might view the insurance industry as ripe for laundering money.

## **The BSA Is all About Criminals and Professional Money Launderers**

Companies are required to comply with BSA regulations that focus on the construct of AML programs. Nevertheless, the greatest money laundering risk to financial institutions is to be used repeatedly to launder criminal proceeds. The costs of reputational risk associated with a material money laundering failure are significant.

To prevent money laundering from occurring, it is imperative that insurance companies review their AML programs and enhance their ability to identify high-risk money laundering transactions.

An important consequence of the global credit crises is enhanced scrutiny of AML programs by regulators and prosecutors. Failure to file SARs will most assuredly result in formal actions against financial institutions, including Cease & Desist Orders or criminal prosecution.

Invest wisely in your AML program now, to minimize the risk of failing to file SARs.

*By Rob Goecks, MBA, CPA, CAMS, LIMRA Senior Regulatory Consultant. Mr. Goecks has 37 years of BSA / AML experience. Call (877) 843-2641 to learn more about LIMRA's AML Independent Testing and Dynamic Risk assessments.*

## **"Where" — The Next Big Thing in Social Media**

Social media sites have done a great job of providing a platform for discussing the questions of "what, why, and when" of our business and personal lives. Until recently, social media sites have not done a very good job of providing a means of discussing the "where" of our lives. New tools are being developed to allow users to include location information within social media content, managed primarily through software applications for smart phones. This article will discuss the rise of location-based social media and "geo-tagging," and propose issues for compliance professionals to consider about this new dimension of social media.

### **What Is Location-Based Social Media?**

Location-based social media allows users to voluntarily disclose their locations, and is largely tied to smart phones like Blackberries or iPhones. Specialized software determines the user's location by accessing a smart phone's GPS, or by using local cell phone towers. Next, location details are matched to a database that provides

information about nearby businesses, landmarks, or even other users. Users can then interact with social media sites to provide information about their activities, local business ratings, or even to find nearby friends.

Location-based social media sites exist as entities unto themselves. Location-based applications also push data into well-known sites like Facebook.com, provided the user has given the software the necessary account permissions. A “geo-tag” is basically the location element of a social media post. Other elements include the user’s name or “handle,” user comments, time stamp, etc. The act of disclosing one’s location through location-based social media is referred to as a “check-in.” Check-ins are usually tied to a specific landmark or business.

### ***Who Offers Location-Based Social Media and What Are the Differences?***

There are a number of location-based social media services. Four companies lead the pack, however: Facebook Places, Foursquare, Gowalla, and Twitter.

Facebook Places is available as a “native” application for the iPhone only. Until Facebook releases Android and Blackberry versions of Places, owners of those devices can access Facebook Places through <http://touch.facebook.com>. Facebook Places does not offer unique features at this time. Notably, both Foursquare and Gowalla (both described below) can integrate with Facebook Places.<sup>1</sup>

Foursquare is a downloadable application with versions available for iPhones, Blackberries, and Android OS smart phones. Foursquare has a complex rewards system that provides virtual “badges” to mark certain degrees of use, allowing the user with the most “check-ins” at a specific business or location to be named the “Mayor” of that location. Mayors are frequently given discounts or freebies because of their presumed customer loyalty.

Gowalla’s offering is similar to Foursquare, with a twist — Gowalla users can share favorite locations.

Finally, there’s Twitter. Most people are familiar with Twitter as a microblog site. However, at the bottom of the familiar “What’s Happening” box, the Twitter Web site provides users with the option to “Add Your Location.” Twitter’s use of location information does not appear to be very sophisticated at this time. Despite this, we cannot discount Twitter or Facebook, as they both have large user communities.

### ***How Will Producers Use Location-Based Social Media?***

While some ideas are starting to emerge,<sup>2</sup> the ultimate use of location-based social media is not clear. Online discussions show widely varying opinions.<sup>3</sup> Some believe that location-based social media will have no place in the marketing or sale of financial products and services. Others see location-based social media as a means of marketing, allowing financial professionals to “hang a virtual shingle.” A virtual shingle leverages the concept of proximity. Since location-based social networks tell users who or what is nearby, merely creating a listing will alert people in the physical area of the existence of a producer’s office. While obviously not a sophisticated marketing strategy, this certainly could get the attention of people visiting a landmark or drinking a cup of coffee nearby.

Location-based social media can also be event-driven. As stated previously, some location-based social networks offer a “badge” system that describes particular behaviors, like checking-in from a boat or from a series of airports. Industries outside financial services create event badges that are issued for a short period of time, tied to a specific location; for example, a convention or conference. This creates opportunities for marketing to customers with common interests who are within a specific geographic region.

To understand more of the potential of location-based social media, we must again look outside the financial services industry. The History Channel, for example, has partnered with Foursquare.<sup>4</sup> Whenever a user is near a historic place, “friends” of The History Channel will see a “tip” from The History Channel. The tip is a snippet of information about the location. The History Channel provides tips for diverse locations, from the Washington Monument to Disney’s Magic Kingdom.

I am not aware of any case study that indicates that location-based social is the next “killer” functionality which will drive sales of financial products and services. However, location-based social media does provide a means of addressing the question of “where.” Based on the adoption of location-based social media by national brands like The History Channel, MTV, Zagat, *People*, and *Bon Appétit*, it is hard to imagine that location-based social tools will disappear anytime soon. Consider this: Location-based social media tools get users to voluntarily disclose location information, provide thoughts and ratings, and enjoy rewards and benefits, while creating a valuable database about consumer habits — all of which are potentially viewable at a national level.

## Compliance and Risk Management

Firms that elect to leverage or partner with location-based social media applications should be prepared to address the same concerns that exist for all other social media.

The basic issues include:

- Data capture and retention
- Advertising and sales literature review
- Licensing and registration disclosure, where applicable
- Risk of encouraging “testimonials”

If location-based social media offers an extraordinary challenge beyond that common to other forms of social media, that challenge is privacy. If other forms of social media create concern about non-public personal information, location-based social media creates concerns about personal safety, as it specifically pinpoints an individual’s whereabouts. Before adopting location-based social media at their firms, risk managers should carefully consider the potential risk for employees and customers, especially at conferences or live events where location-based social media might be leveraged. While short-term controls might include a prohibition on the use of location-based social media, this approach may not ultimately be practical as personal ownership of smart phones — outside corporate control — continues to increase. Best practices have not yet emerged for social media, much less for location-based social media, so this issue will be one to watch for some time.

Location-based social media, like other social media, is not a compliance problem per se. Yes, there are challenges to overcome, but technologies exist that allow compliance professionals to monitor and moderate the use of social media. Further, FINRA Regulatory Notice 10-06 gives the compliance community several basic operating principles, the most important of which is that the old rules apply.<sup>5</sup> Social media is merely a new platform for communication. Therefore the question is not, “What rules apply?” but rather, “How do we apply the rules we already know and understand?” The application of the rules is in turn driven by the demands that business leaders place on the use of social media. Once the business requirements are known, the application of rules will become more apparent, and the compliance issues will ultimately be reduced to the common issues of time, talent, and treasure.

## Conclusion

Location-based social media is an important emerging trend within the larger subject of social media. While social media sites have allowed users to provide data about “who, what, and when,” location-based social

media provides the “where.” This important addition can provide valuable data to marketing professionals, and opportunities for producers to engage with the local community in a new way. The future of location-based social media in the financial services industry is by no means assured. However, because it answers the essential question of “where,” and given the adoption of location-based social media by other industries, it appears likely that the financial services industry will begin to use location-based social media. As with any other compliance or risk issue, the business case and desired use will ultimately drive the compliance issues and response.

*By Stephen Selby, Director of Regulatory Services, LIMRA. Please contact Stephen if you have any questions about social media compliance, at 860-285-7858 or [sselby@limra.com](mailto:sselby@limra.com). Connect with Stephen at <http://www.linkedin.com/in/stephenselby>.*

## What Is Next for Life Settlements?

For the past year a cross-functional task force led by the SEC studied the life settlement business from all angles and recently issued its report advising the Commission on whether market practices and regulatory oversight could be improved.

They studied all aspects of transactions where an insurance policy owner sells a life insurance policy to a third party for an amount that exceeds the policy’s cash surrender value, but is less than the expected death benefit. The task force itself was composed of experts, authors, participants, and regulators from many disciplines. In total the task force met with 23 outside groups including industry participants knowledgeable about the life settlements market. Outside the settlement market, the task force also met with the Financial Industry Regulatory Authority (FINRA), the U.K.’s Financial Services Authority (FSA), the U.S. Government Accountability Office (GAO), and state insurance commissioners and securities regulators and their representatives.

The task force looked at the current state of regulation, specifically what regulations apply to the multiple participants in these transactions, and finally their impact on policy owners and investors. The [report](#),<sup>6</sup> issued July 22, 2010, makes five recommendations:

- The Commission Should Consider Recommending to Congress that It Amend the Definition of Security under the Federal Securities Laws to Include Life Settlements*
- The Commission Should Instruct the Staff to Continue to Monitor that Legal Standards of Conduct Are Being Met by Brokers and Providers*

- C. *The Commission Should Instruct the Staff to Monitor for the Development of a Life Settlement Securitization Market*
- D. *The Commission Should Encourage Congress and State Legislators to Consider More Significant and Consistent Regulation of Life Expectancy Underwriters*
- E. *The Commission Should Instruct the Staff to Consider Issuing an Investor Bulletin Regarding Investments in Life Settlements*

Clearly these recommendations, if adopted in their entirety, would impact the life settlement business. The report acknowledges court decisions asserting the client's property rights to maximize their value under the policy, by allowing them to sell the policy for a value greater than the cash surrender value but less than the death benefit. That said, many life companies and broker-dealers have already implemented controls and procedures to monitor, restrict, or otherwise control the transactions involving life settlements, particularly where their representatives are participants.

The report notes the controls placed by many firms on STOLI (stranger-initiated life insurance) transactions. Mostly those controls stem from a concern that some transactions do not arise, *ab initio*, from a legitimate insurable interest on the part of the investor or beneficiary, but instead are a calculated investment, where the individual applies for the policy with a prior understanding to cede control of the policy to the investor. Here the success of the transaction depends solely on the early demise of the insured. Something the life insurance industry has decried and regulations have prohibited, from the very earliest days of the life insurance hundreds of years ago. Other concerns about STOLI are that it may encourage insurance fraud; or result in a tax liability resulting from forgiveness of premium loans or receipt of incentives from the investor for obtaining the life insurance policy; or limit the insured's ability to obtain life insurance in the future. And, it could make life insurance generally more expensive and less available for other consumers. Investors may be at risk also since insurers may contest STOLI policies on grounds such as fraud or violations of state insurable interest laws.

The first recommendation of the task force goes to the heart of the financial aspects of the life settlement transaction itself — how to monitor the transaction between the investors and the other participants. Making all life settlements securities would bring them under state and federal securities rules and subject all of the participants to oversight by the SEC and FINRA. Any intermediaries, life settlement brokers, any insurance

agent making recommendations, and any person soliciting investors would be subject to registration under the securities laws of the states and the federal level regulators. Some aspects of the transactions are already subject to these laws today. FINRA published notices in 2006 and again in 2009 on expected practices being required when variable policies are involved in transactions where the firm or its representatives are involved (Notice to Members 06-38 and 09-42). Included in these practices are expectations that the firms establish procedures and follow them; in particular, to exercise care and due diligence, and to monitor the transactions for best execution, suitability, and fair and balanced disclosure and sales materials.

The SEC notes that no person or firm has ever registered the securitization of a life settlement with the SEC, and only a few are offered as private investments. One concern here is that no real oversight of the value and validity of the offering can be made by independent sources such as rating agencies, without such registration, but as market participants correctly observe, it will be difficult to assign a rating due to the many obstacles to establishing value, namely the lack of experience and reputation of the prospective issuers of the securitization; the large number of policies needed for life settlements securitizations; questions regarding the reliability of medical reviews of the insured individuals; and the potential timing mismatch of cash flows. Perhaps more significant, however, is that this registration would also subject all participants to the antifraud provisions of the 1933 Act and the investor protections of the 1940 Act.

The report recommends stronger oversight over a number of market participants it perceives as unregulated or perhaps under-regulated, namely the life settlement intermediaries or brokers, and the life expectancy underwriters. These participants are critical to the transaction since no value can be assigned without the life expectancy assessment, and no investors can be found without the broker intermediaries. Estimates of life expectancy of the insured are critical components of the life settlement transaction, affecting the amount paid to the policy owner, the expected timing of payments to investors, and the total value of any securitization. Here again, regulation would include registration, examination qualifications, regulator inspections, and of course, enforcement.

The report notes that privacy concerns also exist. Once the settlement broker has gathered the information necessary to sell a life insurance policy to a provider, it gives that information, including medical information, to potential investors. Today significant privacy risks are attached to that activity since providers, usually

multiple providers, must review and bid on the settlement applications prepared by settlement brokers. Providers may hold but typically resell life settlements or interests in life settlements to investors. Many times the investors in today's life settlement market are large institutional investors seeking to acquire pools of policies. Retail investors also participate in the life settlements market, generally by purchasing fractional interests in settled policies. It is difficult to assess the validity of the valuation without real data on the underlying insured's information, yet the very process places all of that information at risk.

The report also references dozens of cases that FINRA and the SEC have enforced. Here actions allege fraud in connection with life settlement investments. Typically enforcement actions have centered on misrepresentations to investors about the expected profitability and safety of the underlying life insurance policies, including understating or misstating the future durations of the life expectancies of the insured persons. In some, Ponzi schemes were employed to divert new investor funds to pay promised investment returns, or funds were simply converted to the personal use of the perpetrator. FINRA cases involved mostly violations of FINRA rules 3040 and 3030 where representatives engaged in outside business activities or private securities transactions without complying with the relevant FINRA and firm rules.

If the Commission recommends to Congress that it amend the definition of "security" — under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940 — to include life settlements, this would clarify the status of life settlements under the federal securities laws and provide for a more consistent treatment of life settlements under both federal and state securities laws. Under the Securities Exchange Act of 1934, the amendment would bring market intermediaries in the life settlements market under the regulatory framework of the SEC and FINRA. The market intermediaries would be required to register with the SEC and a self-regulatory organization (SRO), such as FINRA, and would become subject to SEC and SRO requirements designed to protect investors from abusive practices and to promote business conduct that facilitates fair, orderly, and efficient markets.

Participants would be required to adhere to rules on dealing fairly with customers, and have a duty to seek to obtain best execution of customer orders, and observe suitability requirements. They would also need to implement requirements that compensation for services be fair and reasonable. The report notes that often the compensation paid to brokers — in some cases as much as 30 percent of the settlement amount — is often not fully disclosed. If deemed securities, the compensation would come under SRO rules mandating that it be "fair and reasonable" and not unfairly discriminate between customers. In some of the enforcement cases cited intermediaries were alleged to have either obscured, not disclosed, or obtained excessive compensation.

The amendment to the definition of "security" would mean that all offers and sales of life settlements, either single life settlements or fractional interests, would need to be registered with the SEC, unless any exemption from such registration requirement was available. Misstatements in the offers and sales of life settlements would be covered by the antifraud provisions in the Securities Act. In addition, the market would benefit from having access to more information about the sales of these securities in the private markets. The SEC has proposed revisions to its rules to require issuers of structured finance products, which would include securitizations backed by life settlements, and that today sell securities relying on exemptions under the Act. This would allow the staff to be in a better position to monitor developments in the market for life settlement securitizations.

The final recommendation suggests better education of the public through investor alerts and other means, regarding the nature, risks, and costs of life settlement transactions. FINRA has already produced investor alerts on this topic, and the report notes that in some cases involving allegations of excessive commissions, people selling or settling a policy were unable to judge the true cost of the transaction in the absence of full knowledge of the facts. The implication is that if the full and complete facts had been disclosed, as would be required of securities, the transactions might have had a different outcome.

*By Larry Niland, LIMRA Senior Regulatory Consultant and former CCO of the John Hancock Financial Network.*

## Senior Investors in 2010

According to the U.S. Department of Labor, overall U.S. unemployment stood at 9.6 percent in August 2010.<sup>7</sup> The AARP recently published an article discussing the particular difficulties seniors have finding work.<sup>8</sup> LIMRA research further shows that many retired seniors, as many as 43 percent, did not retire voluntarily.<sup>9</sup> The message is clear — it's hard for seniors to find work.

It's also hard to find the right investments. The stock market has yet to recover its losses from a high of (DJIA closing) 14,164.53 on October 9, 2007.<sup>10</sup> Thirty-year Treasury yields stand at 3.74 percent as of October 5, 2010.<sup>11</sup>

Unfortunately, LIMRA research shows that of an approximate 30 million pre-retirees (aged 55-70) 55 percent had **less than** \$100,000 in investable assets.

These three forces: 1) a difficult labor market (i.e., reduced income); 2) a difficult investment market; and 3) limited investable assets, challenge the investment selection process and potentially require compliance professionals to reconsider the issue of suitability, especially for senior markets.

Ensuring the suitability of financial product sales includes expressed and implied requirements (i.e., “best practices”). The expressed requirements of suitability focus on the nature of the sale. Was Product “X” a reasonable choice for client “Y” based on the factors listed above, among others? Senior market best practices are addressed in a recent document from the SEC, NASAA, and FINRA, titled *Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors 2010 Addendum*.<sup>12</sup> This is an update to a 2008 publication. The regulators categorize those best practices as follows:

- A. Communicating Effectively with Seniors
- B. Training Firm Employees on Senior Specific Issues
- C. Establishing an Internal Process for Escalating Issues and Taking Next Steps
- D. Taking Information at Account Opening
- E. Ensuring the Appropriateness of Investments
- F. Conducting Senior Focused Supervision, Surveillance, and Compliance Reviews

The regulatory guidance has a consistent thread: selling in the senior market deserves significant, dedicated attention. In fact, sales to seniors are mentioned twice in FINRA's 2010 Examination Priorities, once regarding life settlements, and again regarding variable annuities.<sup>13</sup>

Compliance departments should consider that the guidance jointly provided by the SEC, FINRA, and NASAA are based on feedback from the financial industry. This means that the regulators have a definite notion not only about what is possible, but also about what firms are in fact doing. A standard has been set. In order to meet or exceed that standard, compliance departments need to review the recent guidance from the regulators and develop tests as part of their 3012 process to ensure that if they sell to the senior market, adequate controls are in place and functioning properly.

### Recommended Reading:

1. Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors— September 22, 2008
2. Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors — 2010 Addendum

*By Stephen Selby, Director of Regulatory Services, LIMRA. Please contact Stephen if you have any questions about social media compliance at 860-285-7858 or [sselby@limra.com](mailto:sselby@limra.com). Connect with Stephen at <http://www.linkedin.com/in/stephenselby>.*

<sup>1</sup><http://mashable.com/2010/08/19/facebook-places-guide/>

<sup>2</sup><http://www.insurancemarketinghq.com/2010/08/ways-insurance-agencies-can-use-facebook-places-and-other-location-based-networks/>

<sup>3</sup><http://www.socialturns.com/forum>

<sup>4</sup><http://techcrunch.com/2010/04/22/foursquare-history-channel/>

<sup>5</sup><http://www.finra.org/Industry/Regulation/Notices/2010/P120779>

<sup>6</sup><http://www.sec.gov/news/studies/2010/lifeselements-report.pdf>

<sup>7</sup><http://www.bls.gov/news.release/empsit.nr0.htm>

<sup>8</sup>[http://www.aarp.org/work/job-hunting/info-07-2010/working\\_to\\_find\\_work.html](http://www.aarp.org/work/job-hunting/info-07-2010/working_to_find_work.html)

<sup>9</sup><http://insurancenewsnet.com/article.aspx?id=206509&type=lifehealth>

<sup>10</sup>[http://en.wikipedia.org/wiki/Closing\\_milestones\\_of\\_the\\_Dow\\_Jones\\_Industrial\\_Average](http://en.wikipedia.org/wiki/Closing_milestones_of_the_Dow_Jones_Industrial_Average)

<sup>11</sup><http://www.treas.gov/offices/domestic-finance/debt-management/interest-rate/yield.shtml>

<sup>12</sup><http://www.sec.gov/spotlight/seniors/seniorspracticesreport081210.pdf>

<sup>13</sup><http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p121004.pdf>