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Variable Annuities – Advanced

Introduction

The role of an insurance company and the products it offers is to protect its policy holders against a variety of risks. Insurance protects your property, your health, your life, and business relationships. A by-product of the protection offered by insurance companies has evolved into what we know as annuities; these products are designed to protect policy owners against the risk of outliving a source of income.

A life insurance policy collects premiums, accumulates funds, and invests in an investment portfolio to grow the funds available for paying insurance claims. After a certain period of time, funds are made available to policy holders as accumulated cash value; these funds may be borrowed against or taken out of the policy. Following these same steps, an annuity collects premiums, holds these funds and invests them in securities for a period of time and then makes funds available for withdrawal. More detail will be presented, below.

There are two types of annuities: commercial and private. A private annuity is an unsecured promise from one person to another to make fixed payments for life in return for the transfer of property. This material will deal with commercial annuities. A commercial annuity is a contract issued by a life insurance company which, in return for a specified sum of money, the premium, makes regular payments to an individual, the payee, over a definite period of time, usually the lifetime of the payee.

The Basic Terms
The basic terms you need to know:

Annuity A contract that makes payments over a specified period of
time, usually lifetime or a fixed period of years.

**Premium** The sum of money paid to the insurance company in a single sum or a series of payments in return for the guarantee of a lifetime income.

**Annuitant** The individual on whose lifetime the annuity payments from the insurance company are based, usually the payee.

**Contract Owner** The individual who pays the premium to the insurance company; may or may not also be the annuitant.

**Accumulation Period** The period of time when the annuitant is making contributions to the annuity and building up the value of his/her annuity account.

**Annuitization Phase** The period when the annuitant starts to receive payments from the annuity. This may also be referred to as the payout or distribution period.

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**Variable Annuities and its Best Practices**

Variable annuities’ best practices guidelines are laid out in NASD 99-35 and 00-44 and other FINRA guidelines. These provisions outline the procedures for registered representatives and their supervisors to follow when recommending that a client purchase a variable product. These guidelines should always be observed when considering the recommendation of a variable annuity.

For any responsible registered representative or supervisor, the first step on the best practices pathway is the compilation of detailed client information. The concept of “know your client” is the basis for understanding what investment
vehicles fit which client. The goal of the representative and supervisor is to select suitable investments that meet the clients’ investment goals. In order to move toward this goal, the following are needed:

- **Client Information** - the representative should obtain and retain as much information about the client’s life and financial circumstances as possible. Occupation, age, marital status, number and ages of dependents, investment objectives, risk tolerance, tax bracket, liquid net worth, other investments, savings and annual income.

- **Investment Objectives** – a client’s investment goals and ultimate objectives for their portfolio must be understood. In addition, a representative must thoroughly understand all of the specifications of the variable product recommended and be able to explain them to the client.

- **Full Disclosure** – a variable annuity is a complex product. Full disclosure of all relevant and material facts, such as limited liquidity, surrender charges, withdrawal and tax penalties, fees and risks should be explained in sufficient detail so as to allow the client to make a reasoned decision.

- **Explain Tax Deferral Benefits and Limitations** – tax deferral is a component/benefit of a variable annuity. Under specific provisions of the Internal Revenue Code, earnings of a variable annuity are not taxed in the year earned; taxation is deferred until distributed to the policy owner. Tax deferral should never be misrepresented as “tax free”. Further, a representation that tax deferral assures a greater rate of after-tax return over the period of the annuity should never be made; the fluid application of ordinary income tax and long term capital gains rates on alternative (non tax deferred) investments makes side by side comparisons impossible.

- **Supervisory Review** - a supervisory principal should review the information obtained about the client against particulars of any anticipated variable annuity and the sub-accounts the client has selected to be sure the recommendation is suitable; the review process must be documented, to demonstrate to any regulator who may inquire, that such review did
take place.

- **Supervisory Review and Annuity Replacement** - beyond the review of the suitability of a variable annuity for a client is the supervisory review of a transaction that involves a recommendation that an existing annuity be liquidated in favor of acquiring a new annuity product. Annuity replacement may be a proper recommendation in that contemporary variable annuity products offer an array of riders and options that did not previously exist. It is the thorough review of all aspects of the exchange that must be completely documented so as to withstand the suspicious eye of federal and state regulators. In that variable annuity products are often high paying commissioned products, any recommendation to a client to sell a product in order to purchase a new, similar product is seen by most regulators as a suspicious act. All verifiable reasons for any such recommendation should be documented and retained in the client’s file.

**Retirement and Financial Planning with Variable Annuities**

Most variable annuity products distributed today are complex commodities with an abundance of moving parts. It is due to this complexity that regulatory authorities severely scrutinize the sale of these products. In that a variable annuity is an insurance product and a security product regulatory disclosure is required by both state insurance and securities regulators in addition to the federal securities regulators. Yet given the level of complexity and the level of regulatory scrutiny, funds invested in variable annuities have reached well over one trillion dollars; a lot of money no matter who you are.

Variable annuities are typically long term investments often with holding and penalty periods reaching as long as 14 years. In order to overcome the expenses associated with variable annuity products, substantial holding periods are necessary to assure that the return upon the investment will exceed the product’s costs of acquisition (sales charges to broker/dealers which can be substantial), management fees, and costs of insurance.

While immediate annuities are available for the short term investor, the benefits
and the preferred tax treatment of these investments are minimized and are often set aside for simply placing one’s funds into a well managed separate account available through most investment advisory firms. For those who sell either a deferred or immediate annuity, it is imperative they understand these complexities, be able to clearly explain the workings of the product to clients and prospects, as well as be able to evaluate the suitability of the annuity for the client in light of other, somewhat comparable investment products such as mutual funds and unit investment trusts.

It is only when a registered representative fully understands the advantages and disadvantages of a variable annuity that a reasoned decision can be made by the prospective client that the annuity is the proper investment product to include in their retirement or financial plan.

**Variable Annuity Features**

At the time of the initial client interview, it is important to find out whether a prospective client currently participates in an employer-sponsored retirement plan, and whether the plan is qualified or nonqualified. This inquiry will help determine the state of utilizing any tax deferral provisions of the IRC. A qualified plan seeks to shelter currently earned income by placing earnings into a retirement plan before the earnings are taxed. Once inside a qualified plan, earnings grow on a tax deferred basis; with no loss of current earnings to current taxation, each year more cash would remain to be reinvested for the next annual cycle. However, not every employer-sponsored retirement plan is qualified. Some companies choose nonqualified plans in order to give employees a greater flexibility.

Contributions to a nonqualified variable annuity are not subject to the same contribution limits that apply to qualified plans. They are particularly well suited for clients who have already contributed the maximum amounts to their qualified plan and are looking for additional tax-deferred investment opportunities.

Qualified variable annuities must begin minimum payments by age 70 ½. By contrast, the typical nonqualified deferred annuity does not force annuitization until age 85.
After years of seemingly accelerating evolution, variable annuities are rich with alternative riders and included enhancements. Some of these additions come with express additional costs and fees, while others have simply been built into the price of the product in an attempt to differentiate one issuer’s annuity from the others.

The most obvious change that can be found in today’s variable annuities is the availability of a broad array of sub-accounts. Starting from the inclusion of a fixed account, plus maybe as few as three sub-accounts, today’s variable annuity might include more than 20 available sub-accounts with the ability to rebalance between the selected investments. The contract owner is called upon to analyze these moving parts and come up with a sound investment decision. As these products became more complex, the role of the financial professional increased as they are increasingly called upon to assist the contract owner with understanding the options offered.

Some of the options being offered in contemporary annuities include:

- The ability to receive income while still controlling the principal remaining in the sub-accounts;
- Allowing additional fees to be collected, or dedicate internal funds to provide insurance covering long term care;
- Alternative money managers for the sub-accounts;
- Additional fees may also permit withdrawals from the account without early withdrawal penalties (except as required by the IRS); and
- Additional fees may also fix unrealized gains offering the opportunity to assure certain values will be retained inside the annuity.

These are just a few examples of options being made available to prospective contract purchasers. Just about every issuer tries to set their products apart, so today there are as many different options as there are issuers. The role of the registered representative has become much more important; without the representative’s assistance, the common prospective contract owner would not be able to sort through the product alternatives, the riders available for additional
fees, and understand the difference between the array of sub-accounts. With the importance of the representative, the duty of the representative has soared and the liability exposure for those who sell variable annuities has significantly expanded.

**Immediate vs. Deferred Variable Annuities**

An immediate annuity provides the contract owner with a stream of payments beginning at an agreed-upon point once the annuity is purchased. A deferred annuity is one where the stream of payments is deferred until a later period of time, usually until the contract owner's retirement.

A client's age is one of the most important factors in determining whether an immediate or a deferred variable annuity is most suitable. The older the client, the more suitable will be an immediate annuity, especially for clients who are already retired. As further discussed below, your client may want to consider a split annuity which combines the features of both an immediate and a deferred annuity.

**Split Variable Annuities**

A split variable annuity combines both immediate and deferred annuities. This product allows the client to receive immediate repayment of principal and at the same time to preserve a portion of principal for tax-deferred growth that can return a portion of the original investment.

With a split annuity, a client divides the value of the account into two parts: one part is currently distributed to the client, while the remainder continues to grow inside the policy. The split annuity may be either fixed or variable. Using a fixed-rate annuity for the deferred component can guarantee the remaining portion earns at a rate that will cover the amounts being withdrawn; the withdrawal amounts must be specifically set to equal the fixed earnings or the remaining portion will either earn sums that exceed or deplete the original principal amount.
Joint Life Variable Annuities

A variable annuity can cover the lives of two or more people, all of whom are considered the annuitants on the annuity policy. Joint life annuities fall into different categories with different results particularly as between a "joint life variable annuity’ and a "joint and survivor annuity” or "joint and last survivor variable annuity”.

A joint life variable annuity is a contract that provides a specified amount of income until both parties have died. They are attractive to families who may have a special need child; for example, this annuity would provide income for an elder parent and then for a special child once the parent has died.

Joint and survivor variable annuities are more popular and suitable for married couples. Payments continue to the surviving annuitant for either a fixed time period or for the remaining annuitant’s life. With the changes and financial obligations that may be caused by a spouse's death, the annuity can offer a payment while both spouses are living and a reduced payment after the death of the first spouse. The differential used in the two periods is usually selected by the clients; 75% to the survivor, 66.6% to the survivor, 50% to the survivor and so on.

Variable Annuity Benefits and Options

The annuity as an insurance product has evolved greatly since its commercial application in contemporary America. The competitive market has driven the industry to identify social and economic issues that affect the annuity consumers and adapt to address these issues. The adaptation of commercial annuities includes alternative benefit options and available riders that now make variable annuities a malleable, and complex, investment and retirement product.

Death Benefit Options

Variable annuities offer a minimum guaranteed death benefit. In this way an annuity assures that the survivor, or beneficiary, will get back the original amount invested in the policy if the annuitant dies before the contract is annuitized. Be advised that once the variable annuity contract is annuitized, the death benefit expires absent a relevant provision or a survivor annuitant, and the insurance company becomes the beneficiary.

Some variable annuities allow the client to choose a stepped-up death benefit.
Under this feature, the death benefit may be increased beyond the guaranteed minimum level, calculated by the amount of premium payments minus withdrawals. The purpose of a stepped-up benefit is to lock in the client's investment performance and prevent a later decline in the value of his account from eroding the amount he or she expects to leave to heirs.

**Refund Annuities**

A refund annuity option addresses the possibility that the owner will die before his or her life expectancy and before the stream of payments is utilized. In a refund annuity, the owner is assured that with the owner's premature death, a designated beneficiary will receive at least the remainder of the original amount invested. In this way, the insurance company returns to the beneficiary the amounts invested by the annuitant less any payments actually made to the annuitant prior to their death. The refund may be either a lump sum payment or a stream of payments for a certain period of years.

**Guaranteed Minimum Income Benefit**

Under a guaranteed minimum income benefit, payments will continue to be received until the annuitant dies; however, if the annuitant dies before a predetermined guaranteed period expires, payments will continue to a designated beneficiary until that period ends. For example, with a policy with a lifetime distribution, and a 10-year minimum payment period (often referred to as a 10 Year Certain Period), should the owner die after four years of distribution, the beneficiary will continue to receive distributions for the next six years.

**Long-Term Care Insurance and Nursing Home Waiver**

A long-term care insurance option or rider will pay for nursing and/or home health care if the client becomes seriously ill. This benefit will incur an additional charge to the policy premium.

Some annuities offer a waiver of the surrender charges as an alternative to long-term care coverage. In the event the annuitant is either hospitalized or confined to a nursing home for a specified period, the owner of the contract is allowed to withdraw funds from the annuity that might be needed to meet the expenses or lost income associated with the hospitalization or confinement.
The Role of a Variable Annuity in Long-Term Financial Planning

While many think of variable annuities as retirement vehicles, other long term goals can be served using these products.

Funding Educational Goals

A few long term goals that can be met using a variable annuity include funding for the education of a child or grandchild, the purchase of a home or second home, buying a business, providing for the special needs of children or grandchildren, charitable giving, and assuring that funds will be available in case of the onset of a disability or illness.

Remember that a variable annuity is an insurance company product. As such, there is an insurance component built into the annuity policy. The variable annuity provides a death benefit that assures there will be a certain value available in the event of the owner’s death. The death benefit that is available may exceed the value of the investment accounts held inside the product. It is this fact that provides the rationale for contract owners to acquire an annuity product and pay the added fees associated with the insurance side of this investment. One exception that is made to the tax penalty for early withdrawal from an annuity is in the event of the contract owner’s death or disability.

Annuities are just one of the many investment vehicles suitable for funding college tuition. There are many other vehicles to choose from, including zero coupon bonds or an account established under the Uniform Gift to Minors Act, where the earnings are taxed at the child’s (usually lower) tax rate. Parents or other interested parties can also use a Section 529 savings plan to establish a child’s college fund. Section 529 Plans avoid taxes altogether when they are properly established and maintain compliance with IRS requirements. The plans accumulate tax-free earnings until the funds are withdrawn and used for qualified higher education expenses.
Charitable Gifts

Variable annuities may be used in conjunction with charitable giving. An indirect or alternative commercial annuity can be created as an individual makes a gift or donation to a nonprofit or educational organization in exchange for an income for life and a tax deduction on the contribution. The charitable gift annuity may be funded with cash, valued property, or marketable securities. The charitable entity may create a private annuity to meet the obligation to pay the donor, or it may purchase a conventional insurance issued annuity to meet this obligation.

Variable Annuities and Social Security

In 1935, Congress signed into being the Social Security Act. The intention of Congress in enacting these provisions was to provide a minimal safety net for the poorest of the nation to survive their years of infirmity or when they become infirmed. The Act was conceived at a time when the nation was seeking to recover from the depression of the early 1930s - a time when financial suffering was still in everyone's mind and compassion for those who had been suffering due to no fault of their own. If one examines the law and the Congressional record of the discussion of the Act, there is not a single hint that Social Security would be configured, over time, to be misunderstood by many to be a national "retirement account".

As political speeches and pragmatic financial advisors spread the word about the limitations of Social Security, most of the work force realizes that more than a Social Security benefit will be needed to preserve their lifestyles. The harsh reality is that our society has so focused on current consumption that deferring income for later years is not in our collective mindset. With a real probability that Social Security will fail if maintained in its current configuration, those who do wish to preserve some income for the future look for tools to achieve this goal.

Variable annuities can be coordinated with expected Social Security income. The Social Security Administration provides schedules of anticipated benefits to
participants. Using this information, a retirement planner will analyze the needs of the client at the time of retirement, the periodic payments available from Social Security, contributions from all other investment and business sources, and the shortfall, if any. The retiree has the opportunity to overcome this shortfall by using a variable annuity to provide additional income.

**Comparative Investments - Variable Annuities versus Mutual Funds**

Often a registered representative will attempt to explain the workings of a variable annuity’s sub-account as simply a “mutual fund” inside an annuity. This is an incorrect statement and should not be used to explain this concept; confusion between these investments often takes place in the mind of the client simply by using this to try to explain the sub-account concept.

There are many differences between a mutual fund and a sub-account. It is very important that a representative be able to distinguish, in the client’s mind, between these alternative investments. Since many clients are familiar with the concept of a mutual fund, there is a natural tendency for a client to try to incorporate information they receive about sub-accounts within a concept they already understand. For this reason, it is very important that a representative be able to draw the line between these investments.

**Taxation**

As a mutual fund receives dividends and interest on its portfolio, or realizes capital gains from sales of holdings in its portfolio, it must distribute those amounts to fund owners in the same year in which the fund receives or realizes them. The IRC requires the mutual fund shareowner that receives these distributions from a mutual fund to include them in his or her taxable income for that year. The reporting of earnings and gains for tax purposes occurs whether or not the mutual fund owner actually withdraws the earnings or gain or reinvests it in the fund. Dividends are subject to taxation at ordinary income rates (higher tax rates), while distributed gains are subject to taxation at capital gains rates (lower tax rates).
For variable annuities, taxation on dividends, interest and realized gains from the funds or investments in the sub-accounts are deferred to a later time; annuities are not taxed in the year gains are realized because they are not distributed to an annuitant. Even then, in most cases, the amount of "gain" that is taxed in any given distribution is limited by an exclusion ratio, which is the formula used to determine the amount of principal in the distribution that is not taxed. Distribution of earnings during the annuitization period will be taxed in the year of such distribution; all distributed earnings will incur taxes at ordinary income tax rates (which are higher than long term capital gains tax rates).

The differential tax rates, ordinary income tax rates versus long term capital gains tax rates, is an important issue to understand when comparing a mutual fund to a variable annuity. The fact that an annuity receives preferential income tax treatment in the form of tax deferral until distribution is often presented as a benefit of a variable annuity over a comparable mutual fund. The typical example shows that as time passes, a mutual fund loses funds each year to pay income taxes (usually shown as ordinary income tax rates applied to earnings), while a variable annuity does not. The natural result is that the variable annuity accumulates earnings at a greater rate than will the mutual fund. With the same assumed rate of realized return, with no "leakage" from the variable annuities to pay income taxes each year, the variable annuity will always outperform a mutual fund.

The concern that arises using this type of example is that a mutual fund incurs a mix of ordinary income taxes and long term capital gains taxes. So, when an example uses the higher ordinary income tax rate on all mutual fund earnings, the example artificially uses a higher than expected overall tax rate on the mutual fund earnings. To the extent that many mutual funds are structured to focus on long term gains and not current dividend earnings, these funds would incur taxes on most of its gains at the lower capital gains rates. To present a comparison that does not address this issue would be considered to be an intentional misrepresentation and could be considered to be improper, or even fraudulent.
Withdrawal Penalties

Should a variable annuity owner withdraw a portion of funds from their annuity before the owner reaches age 59 ½, under the policy contract such withdrawal would then be subject to ordinary income tax, a penalty of an additional 10% early withdrawal tax, plus any penalty that may apply to the annuity for withdrawals that exist under the policy contract.

In contrast, a mutual fund incurs no such penalties. While a mutual fund is subject to the ups and downs of the financial markets, a gain or loss on the investment may be realized upon liquidation and withdrawal of cash from the fund. Due to the fact that a mutual fund is taxed each year, should a withdrawal take place, the fund shareholder will incur taxes only on gains that have not previously been taxed. No additional tax penalties or withdrawal penalties under any investment contract are incurred.

Switching Investments

Should a client determine that investments in their current portfolio are not performing as expected, or are not proper given their current personal/financial situation, they will want to switch their investments.

Whenever investments shift and funds are moved from one mutual fund to another even within the same “fund family”, such a shift is considered a sale and purchase of the mutual funds; this may be a taxable event. Any gain realized by the mutual fund shareowner, and not previously taxed, will then be taxable. This statement does not apply if the mutual funds are being held inside a qualified retirement plan. With variable annuities, funds may be shifted among various sub-accounts inside a single variable annuity without being considered taxable sales. There may, however, be limitations on the number of such transfers permitted under the policy contract; these restrictions will vary from one variable annuity contract to another.

In addition, IRC, Section 1035 permits a variable annuity holder to switch the entire annuity by liquidating the current annuity and purchasing a new annuity without penalty or current taxation.
In order for an IRC Section 1035 exchange to take place, certain conditions must be met:

- The owner must be identical in both contracts;

- The exchange must be an annuity contract for another annuity contract - not for a life insurance product;

- The original issuer must be informed that an exchange is being made pursuant to IRC Section 1035; and

- The original contract must be assigned to the new issuer, or (if a partial exchange is involved), the funds withdrawn from the original annuity less any surrender charge must be transferred directly into another annuity (e.g., the check issued to the client by the first issuer must be endorsed over to the second issuer).

This provision adds a level of flexibility to a variable annuity that is not available to a mutual fund. In that a mutual fund holder may be reluctant to sell and purchase a more appropriate investment because taxes may be then due upon previously non-taxed gains, the holder may hold an inappropriate investment in their portfolio. This holding could have a detrimental effect on the holder's overall investment return.

**Probate or Not**

Under a variable annuity, a beneficiary is designated to receive the remaining interest in the annuity in the event of the death of the policy owner. The transfer of ownership interest takes place under the annuity policy contract, not under law (by will or trust).

Compared to a mutual fund, no beneficiary provisions exist under the fund instrument. To transfer ownership interests in mutual funds upon the death of the shareholder, typically the mutual funds must pass through the courts in the probate process. This transfer can be costly and lengthy and detrimentally affect the overall value of the assets transferred to the holder’s heirs. This transfer process can be somewhat mitigated through the use of a properly drafted trust
instrument; however, this too can be expensive to create.

**Case Studies**

The following represent investigations and disciplinary actions for improprieties involving variable annuities.

**Branch Manager Charged with Supervisory Failures**

In 2006 and 2007, the NASD charged two Utah brokers, Jeffrey Doerr and David Corn, with facilitating a hedge fund manager’s deceptive practices to market timing through variable annuities offered by three different life insurance companies.

Both Doerr and Corn were registered with Prudential Securities, Inc. (PSI)—now known as Prudential Equity Group—but have since left the firm. NASD also charged the brokers’ branch manager, Darrel Trost, with failing to supervise their activities. “Deceptive market timing violates ethical standards and can harm long-term investors in mutual funds and variable annuities,” said James S. Shorris, NASD Executive Vice President and Head of Enforcement. “Brokers who actively facilitate the deceptive market timing conduct of their customers will be held accountable for this kind of misconduct.” In its complaint, NASD alleges Doerr and Corn actively facilitated market timing activities by their customer—Paul Saunders, a hedge fund manager, registered broker and Chairman, CEO and majority owner of James River Capital Corporation of Richmond, VA. NASD fined Saunders $2.25 million in October 2006—the largest sanction ever against an individual for deceptive market timing.

NASD alleges that Doerr and Corn assisted Saunders by opening 20 brokerage accounts at PSI for him between 2000 and 2003, in the names of numerous limited partnerships he created that had the same beneficial owners as his market-timing hedge fund. NASD alleges Doerr and Corn knew or should have known that Saunders would use these accounts to market time variable annuities and that the limited partnerships shared the same beneficial owners. NASD
further alleges that, with Doerr and Corn’s assistance, Saunders executed approximately 900 variable annuity sub-account exchanges between October 2001 and September 2003 that violated insurance company restrictions or limitations, earning approximately $5.2 million in profits. Doerr and Corn each made approximately $45,000 in commissions from this activity. In its complaint, NASD alleges that after Saunders began market timing sub-accounts through Doerr and Corn, the brokers received notices from insurance companies attempting to restrict or block Saunders from further market timing. The complaint alleges that after receiving the restriction notices, Doerr and Corn assisted Saunders in evading the insurance company restrictions by engaging in the following deceptive practices, separately or together:

- Opening multiple contracts for Saunders in a variable annuity, in the names of different related limited partnerships, and simultaneously entering trades for Saunders in those annuity contracts.

- Handling Saunders’s purchase of new contracts in a variable annuity in the names of other limited partnerships that shared the same beneficial owners as the partnerships that had been restricted or blocked by insurance companies.

- Handling Saunders’s purchase of new contracts in the same variable annuity, with Saunders identifying a different annuitant. The brokers knew or should have known that all the annuitants used by Saunders were employees of entities Saunders controlled.

- Submitting applications for Saunders in much smaller dollar amounts after certain insurance companies rejected an annuity contract because it was purchased with a large initial investment.

The complaint alleges Doerr and Corn used four separate broker identification numbers to help Saunders evade efforts by insurance companies to restrict his market timing activities. After one annuity contract opened with one number restricted, the brokers would open a new contract with a different number.

NASD also charged Trost with failing to supervise Doerr and Corn. Trost knew or should have known Saunders opened accounts for limited partnerships that
shared common ownership, and that Saunders was engaging in prohibited market timing. He reviewed notices from insurance companies restricting Saunders’s market timing, but did not restrict the accounts from continuing that activity. The complaint further alleges that Trost failed to adequately respond to repeated requests by PSI’s Compliance Department regarding Saunders’ market-timing activities.

NASD also alleges Doerr, Corn and Trost also separately failed to update each of their Forms U4 for over seven months—and then only at the prompting of NASD staff—to reflect that each was the subject of an investigation that could result in a disciplinary proceeding.

The complaint follows related NASD actions not just against Saunders, but against PSI. On Aug. 28, 2006, NASD, federal and state securities regulators and the Department of Justice announced settlements and $600 million in monetary sanctions against PSI for misconduct involving improper market timing of mutual funds.

**Fined for Lack of Producing Branch Manager**

Former Raymond James Branch Manager Donna Vogt Barred for Making Unsuitable Recommendations to Retirees.

NASD has fined Raymond James Financial Services, Inc.(RJFS) of St. Petersburg, FL, $2.75 million for failing to maintain an adequate supervisory system to oversee the sales activities of over 1,000 producing branch managers working in offices throughout the United States.

In a related action, NASD permanently barred one of those branch managers—Donna Vogt, who worked for the firm from her home office in Cambellsport, WI.

Vogt recommended unsuitable mutual fund and variable annuity purchases to elderly or retirement age customers, and made misleading statements to customers in correspondence. RJFS failed to detect these sales practice abuses because of deficiencies in its supervisory system. RJFS also failed to have an adequate system in place to properly supervise sales of variable annuities. “RJFS’s supervisory system was inadequate because it allowed producing
branch managers to supervise themselves,” said James S. Shorris, NASD’s Executive Vice President and Head of Enforcement. “This flawed supervisory system created a situation where the unsuitable sales of variable annuities and risky mutual funds to elderly and risk-averse customers went undetected.”

From early 2000 through September 2004, RJFS employed over 1,100 producing registered principals, or branch managers, most of whom worked in small, geographically dispersed offices. These branch managers were allowed to act as the primary supervisors of their own business activities. They approved their own transactions, opened and accepted new accounts, and reviewed their own correspondence. The firm relied on an electronic transaction surveillance system maintained by RJFS’s Compliance Department, and a series of exception reports, to flag transactions that required further review. It also assigned supervisory responsibility for these 1,100 branch managers to three sales managers. The activities commonly associated with daily supervision, however, were conducted by the branch managers, who in many cases, in effect, supervised themselves. By permitting these principals to engage in self-supervision, RJFS’s supervisory system was not reasonably designed to achieve compliance with securities rules and regulations.

One such producing manager was Donna Vogt, (she is already listed above) whose sales practice violations went undetected for approximately four years. Vogt was the branch manager and the only registered person working in her office in Wisconsin. She maintained hundreds of customer accounts and sold mainly mutual funds and variable annuities. Many of her customers were of retirement age or older.

NASD found that, in determining which products to recommend, Vogt treated her customers as a homogeneous group, regardless of age, financial status, investment experience and objectives. Of her approximately 700 accounts, more than 90 percent listed their primary investment objective as “growth” and risk tolerance as “medium.” RJFS never questioned the fact that Vogt listed these objectives and strategies for almost all of her customers. In fact, the person who reviewed and accepted the customer account documents was Vogt herself. NASD found that Vogt recommended unsuitable purchases and concentrations of aggressive mutual funds and variable annuities to at least five customers who
were elderly, retired or nearing retirement. These transactions were unsuitable due to the over-concentration in aggressive growth funds, and because access to their funds was limited by the variable annuity surrender charges.

RJFS failed to detect or prevent these unsuitable transactions by Vogt. The firm also failed to prevent Vogt from sending misleading communications to some of her customers, in part because the firm allowed all of its producing branch managers, including Vogt, to review their own incoming and outgoing correspondence.

NASD found additional supervisory deficiencies at RJFS. The firm failed to maintain an adequate system and written procedures to reasonably supervise sales of variable annuities. Branch managers reviewed and endorsed most of their own variable annuity activities. RJFS’s Compliance Department screened variable annuity purchases using only three exception reports, which did not screen variable annuity transactions for suitability based on customer net worth, annual income, investment experience or concentration of variable annuity holdings as a percentage of net worth. As a result, Vogt’s unsuitable variable annuity recommendations went undetected. In addition, there was no system in place at the firm for reviewing the suitability of variable annuity sub-account transactions recommended by branch managers, nor was there any system for ensuring that a record of sub-account recommendations and transactions was maintained. NASD also found deficiencies in the firm’s branch audit program, and found that RJFS failed to maintain certain books and records.

Neither RJFS nor Vogt admitted or denied the charges, but consented to the entry of NASD’s findings.

**Conclusion**

Variable annuities are complex securities products that have peaked the interest of state and federal regulators. While complex, there are places for variable annuities within the investment portfolio of many investors. The nature of the product lends itself to retirement and long term financial planning. So long as the limitations of the product are understood, a registered representative should be willing to offer a variable annuity to prospective clients with confidence.