July 1, 2013

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street N.E.
Washington, D.C. 20549-1090

Re: Request for Data and Other Information Regarding the Duties of Broker-Dealers and Investment Advisers (Release No. 34-69013; IA - 3558; File No. 4-606)

Dear Ms. Murphy:

The Association for Advanced Life Underwriting ("AALU") appreciates the opportunity to provide these comments to the Securities and Exchange Commission ("Commission" or "SEC") in response to the above-referenced release ("Release") requesting data and other information regarding the standards of conduct and other obligations of brokers-dealers and investment advisers when providing personalized investment advice about securities to their retail customers.[1]

AALU is a nation-wide organization of more than 2,000 life insurance agents and professionals who are primarily engaged in sales of life insurance used as part of estate, charitable, retirement, and deferred compensation and employment benefit services. Life insurance enables individuals and families from all economic brackets to maintain independence in the face of potential financial catastrophe, helping relieve pressure on government entitlement programs. It is unique in guaranteeing the delivery of financial security at precisely the moment it is needed, while contributing significantly to the nation's storehouse of savings and investment capital. Seventy-five million American families rely upon the important financial security that life insurance products provide, and its availability to these families must be preserved.

As discussed in more detail below, AALU members engage primarily in the sale of life insurance and, as part of their service, offer clients related variable products, such as variable life and variable annuities. These bundled products offer consumers investment choices for their accumulating cash values – the variable element of the product – with separate guarantees from the issuer such as a guaranteed death benefit and lifetime income guarantees. These often are important options for customers seeking to address their life insurance protection and retirement needs and have been recognized as even more important in recent years. It is the sale of these products that triggers broker-dealer registration and SEC, FINRA, and state securities regulation and oversight for those producers. Therefore, any major changes in SEC regulation of broker-dealers, particularly if it imposes greater costs, uncertainty, and potential liability, would have a

[1] Duties of Brokers, Dealers, and Investment Advisers, Release No. 39-69013, 78 Fed. Reg. 14,848 (Mar. 7, 2013) ("Release").

www.aalu.org

Virginia: 11921 Freedom Drive, Suite 1100, Reston, VA 20190 | T: 703.641.9400 | T: 888.275.0092 | F: 703.641.9885
Washington, DC: 101 Constitution Avenue NW, Suite 703 East, Washington, DC 20001 | T: 202.772.4638 | F: 202.742.4479

significant impact on these producers and could potentially affect their relationships with, and their ability to serve, their customers.

The Release poses a number of questions, designed largely to inform the Commission's consideration of whether to impose a "uniform" fiduciary duty on broker-dealers and investment advisers, or various alternatives. Our letter does not comment on all of the questions in the Release, many of which are not relevant to the business of our members. We have endeavored to provide detailed information in areas where we believe AALU, based upon our members' business and expertise, can be most helpful in furthering the Commission's understanding of the important issues raised in the Release.

AALU Supports Clear, Concise Disclosures to Customers of Broker-Dealers and Investment Advisers about their Roles and Obligations, Product Offerings, and Material Conflicts.

We begin by stating our support for the Release's regulatory alternative number one,[2] with certain conditions, and stating why we believe the Commission should pursue it. The Release states that, under alternative one, the Commission could apply a "uniform requirement for broker-dealers and investment advisers to provide disclosure about (a) key facets of the services they offer and the types of products or services they offer or have available to recommend; and (b) material conflicts they may have with retail customers, without imposing a uniform fiduciary standard of conduct."[3] AALU has supported the approach of roles and conflicts disclosure for years.[4]

Indeed, we believe the Commission's pursuit of a fiduciary duty for broker-dealers is a solution – a label – in search of a problem, when the most effective way to address the Commission's concerns would be to identify the harm the Commission believes results from the different standards applicable to broker-dealers and investment advisers and offer targeted reforms to directly address such harm.[5] We suggest that precious time and scarce SEC resources could have been better spent.

---

[2] Release at 14,858.

[3] *Id*.

[4] *See* Letter from David J. Stertzer, Chief Executive Officer, AALU, to Marcia E. Asquith, Senior Vice President and Corporate Secretary, FINRA (Dec. 22, 2010), *available at*: www.finra.org/Industry/Regulation/Notices/Comments/P122714 ("AALU-FINRA Letter"); *see also* Letter from David J. Stertzer, Chief Executive Officer, AALU, to Elizabeth M. Murphy, Secretary, SEC, File No. 4-606, (Aug. 30, 2010), *available at*: http://www.sec.gov/comments/4-606/4606-2631.pdf ("AALU-SEC Letter").

[5] *See* Retail Investor Protection Act, H.R. 2374, 113th Cong. (2013) (as reported by H. Comm. on Financial Servs., June 19, 2013). The Retail Investor Protection Act, introduced by Representative Ann Wagner (R-MO-2), would require the SEC to identify specific harm and then to craft a rule or other remedy to address that harm cost effectively. The House Financial Services Committee approved the legislation by a vote of 44-13 on June 19, 2013.

To date, the only issue upon which the Commission has based its five-year effort in support of a uniform fiduciary duty for broker-dealers and investment advisers is the issue of investor confusion. This issue was highlighted in a 2008 RAND Corporation report, which found that investors were confused about the legal differences between brokers, dealers and investment advisers, although investors were nonetheless very satisfied with their own financial professionals. [6] RAND summarized its findings as follows:

> Overall, we found that the industry is very heterogeneous, with firms taking many different forms and offering a multitude of services and products. Partly because of this diversity of business models and services, investors typically fail to distinguish broker-dealers and investment advisers along the lines that federal regulations define. Despite their confusion about titles and duties, investors express high levels of satisfaction with the services they receive from their own financial service providers.[7]

Of course, this level of investor satisfaction occurred within a diverse financial marketplace – one in which brokers, investment advisers, and insurance producers operate under rules designed for their specific products, services, and customer relationships, and within which the obligations of financial professionals to customers may be further shaped by agreement and by their particular relationships. The investors surveyed by RAND had a wide variety of choices, as they do today. For example, they could choose a financial planner registered as an investment adviser who works for a fee to provide advice in developing a financial plan. They could choose other registered advisers who manage accounts for an asset-based fee. They also could choose an SEC, FINRA, and/or state-regulated broker-dealer, who is in the business of selling securities for a commission and provides investment advice incidental to that business. They could purchase life insurance with a variable component from an insurance producer who also holds a license as a registered representative under SEC and FINRA rules, as well as state securities and insurance licenses. They could choose a financial professional who provides a variety of these and other services separately, or in combination.

Perhaps an element of the level of investor satisfaction found by RAND was the fact that investors of all levels of wealth and sophistication have enjoyed access to financial services because of the diversity of financial professionals and variety of options available. A one-size-fits-all standard designed for the sake of uniformity could mean that some investors will be left out. These individuals very well may be smaller and mid-sized investors. From the perspective of our members, there is deep concern that the imposition on broker-dealers of a new fiduciary standard will increase compliance costs, expand liability, and result in the withdrawal of some professionals from the sale of SEC-regulated products, such as variable life and variable annuities, resulting in a further reduction of investor choice.

---

[6] Angela A. Hung *et al*., *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, RAND INST. FOR CIV. JUST. (2008), *available at*: http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf ("RAND Report").

[7] RAND Report at xiv.

How, then, should the Commission address the issue of investor confusion, if investors are generally satisfied, but confused? How should the Commission address the issue of conflicts disclosure – which appears to be the essential difference articulated by the Commission in the standards applicable to broker-dealers and investment advisers?[8]

AALU members believe our customers fully understand the role in which our members operate, but we also believe many customers feel buried under the weight of required disclosure and account-related documents. Of course, we know that both the Commission and FINRA have heard this complaint year after year, over many decades, and yet regulators to date have not written the kind of rules that would facilitate the type of simple, brief, "plain English" disclosures investors want and need.

For this reason, we support the Commission's alternative one, but with this important clarification. The "uniformity" of disclosures it suggests should not result in page-after-page of voluminous and dense disclosures, which, like the investment advisor's brochure, inevitably will remain unread.

As we stated in our comment letter in response to FINRA's Notice 10-54,[9] we believe investors would benefit from a short and simple disclosure statement that is presented by financial professionals at the outset of a client relationship. This statement should convey the types of accounts and services provided, as well as the roles and responsibilities of the financial professional. The statement should also include information about the nature of the services provided and the obligations of the service provider in his or her role, for example, and any associated conflicts or contractual obligations that limit the products he or she can offer or that may impact the recommendations made.

With respect to format and delivery, the primary structural goal in the design of a disclosure statement should be to communicate material information as succinctly and plainly as possible, making additional layers of information available to the investor as needed. The delivery of this information should be flexible. Retail customers should be able to access hard or electronic copies of disclosure statements, and both should provide opportunities to access additional information as it is needed (through the use of hyperlinked documents or websites and/or other means).

Over the past two years, AALU, working with its Regulatory Reform Committee, comprised of its expert life insurance agent members, and its Regulatory Task Force, made up of representatives from many of its life insurance carrier partners, broker-dealers, and investment advisers, has developed such a document, which we attach for the Commission's further information (Attachment A to this letter). Our goal was to develop a simple, user-friendly "first layer" document, which, of course, could be used to direct a customer to additional information, if the customer wishes. This particular sample disclosure document was written to accommodate

---

[8] Of course, broker-dealers are required to disclose specific conflicts in numerous areas. *See infra* text accompany notes 15-18.

[9] *See* AALU-FINRA Letter, *supra* note 4, at 4-5.

a financial services firm that offers insurance, broker-dealer services, and investment advisory services, and it therefore carefully distinguishes the roles and responsibilities relating to each area. Of course, the Commission may have in mind different or additional disclosures under its alternative one, but we would strongly argue against a "more is better" approach.

In the Release, the Commission acknowledges, "Section 913 of the Dodd-Frank Act does not mandate" that the Commission undertake a rulemaking to impose a uniform fiduciary duty on broker-dealers and investment advisers, and the "Commission has not yet determined whether to commence a rulemaking."[10] We therefore urge the Commission to use its time efficiently and, if it determines to move forward with rules, develop those rules in a targeted approach to address the specific problem the Commission has identified – investor confusion.

Our members and their businesses currently operate under many layers of regulation designed for the protection of retail customers when they sell products subject to the Commission's jurisdiction, particularly variable life insurance products. The imposition of a fiduciary duty standard offers no clear benefit that cannot be addressed through targeted rules of conduct.

The Release also states that the Commission, in considering various options for a potential standard of conduct applicable to broker-dealers and investment advisers "will take into account existing regulatory obligations that apply today to broker-dealers and investment advisers."[11] Thus, the Commission must consider the additional regulatory obligations applicable to insurance producers who sell products subject to the Commission's jurisdiction as licensed registered representatives of broker-dealers.

To begin, broker-dealers are subject to the antifraud provisions of the Securities Exchange Act, which prohibit misstatements or misleading omissions of material facts, as well as fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities.[12] Broker-dealers must deal fairly with customers and the public under FINRA requirements to observe high standards of commercial honor and just and equitable principles of trade,[13] and engage in fair and balanced communications with the public.[14] Broker-dealers are also required to provide timely and adequate confirmation of transactions,[15] provide account

---

[10] Release at 14,848.

[11] *Id.*

[12] Securities Exchange Act of 1934 §§ 10(b), 15(c), 15 U.S.C. § 78(a), *et seq*. (2012) (and SEC rules promulgated there under); *see also* FINRA Rule 2020 (Use of manipulative, deceptive, or other fraudulent devices).

[13] FINRA Rule 2010 (Standards of commercial honor and principles of trade).

[14] FINRA Rule 2210 (Communications with the public).

[15] *See* SEC Rule 10b-10, 17 C.F.R. § 240.10b-10 (2013) (Confirmation of transactions); FINRA Rule 2232 (Customer confirmations).

statements,[16] and disclose certain conflicts of interest.[17]

Broker-dealers are subject to comprehensive SEC and FINRA requirements for the recommendation and sale of securities. FINRA Rule 2111 requires a broker-dealer to have a reasonable basis to believe that each securities transaction or investment strategy involving a security recommended by a broker-dealer is "suitable" for the customer based upon very specific information that the broker-dealer is required to gather from the customer and maintain, regarding the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose.[18] As the SEC has acknowledged, specific suitability, disclosure, and due diligence requirements apply to certain securities products, including penny stocks, options, mutual fund share classes, debt securities and bond funds, municipal securities, hedge funds, variable insurance products, and non-traditional products, such as structured products and leveraged and inverse exchange-traded funds.[19]

One such product-specific rule is FINRA Rule 2330, which sets forth extensive and detailed sales practice requirements for recommended purchases or exchanges of variable annuities. These include detailed disclosures about the product, including disclosures of its various features, such as the potential surrender period and surrender charge, potential tax penalty if customers sell or redeem early, mortality and expense fees, investment advisory fees, potential charges for and features of riders, the insurance and investment components of deferred variable annuities, and market risk. These types of disclosures, detailed as to the features and risks of particular types of investment products in relation to their benefits, are meaningful for investors. Together with information relating to costs and fees provided in confirmations, account statements and other materials, these types of disclosures enable investors to comprehensively evaluate the products and all associated fees and charges.

Existing disclosure and other customer protection requirements are buttressed by the requirements for daily suitability review by a registered, qualified principal of the broker-dealer of all recommended transactions effected by a broker-dealer – a review that is heightened for products that present higher risks. Moreover, these internal supervisory and audit procedures are further buttressed by the robust examination programs administered by the SEC and FINRA, and state securities regulators. The frequency and intensity of FINRA audits of broker-dealers means that many potential problems will be detected and corrected through the examination process.

---

[16] SEC Rule 15c3-2, 17 C.F.R. § 240.15c3-2 (2013) (Customers' account statements); *see also* FINRA Rule 2340.

[17] FINRA Rule 5121 (Public offerings of securities with conflicts of interest); FINRA Rule 3040 (Private securities transactions of an associated person).

[18] FINRA Rule 2111 (Suitability).

[19] Our previous letter to the Commission included, as an attachment, an SEC staff memorandum entitled "Standards of Conduct Applicable to investment Advisers and Broker-Dealers," which was prepared for the Commission's Investment Advisory Committee on May 17, 2010 and detailed the above described regulatory requirements. *See* AALU-SEC Letter, *supra* note 4, at 36.

The anticipation of a near-term examination also has a deterrent effect on adverse behavior and creates a strong incentive for broker-dealers to continuously monitor and adhere to regulatory requirements, including the various disclosure requirements mentioned above.[20]

In addition, as further discussed below, insurance producers who sell variable products, which are among the most highly-regulated financial products sold to retail customers, are subject to multiple layers of regulation and oversight – by the Commission, FINRA, state securities regulators (including in each state in which they operate, which often results in oversight by multiple state securities regulators), and state insurance regulators (also in each state in which they are licensed and operate, which again results in oversight by multiple state insurance regulators). Insurance producers are subject to detailed requirements by the carriers who appoint them; robust internal supervisory procedures by the broker-dealers with which they are affiliated, and frequent and comprehensive regulatory examinations by the regulators who exercise jurisdiction over them.

The design of variable life insurance products requires medical and often financial underwriting that goes beyond the requirements for traditional securities. The complexity and breadth of applications relating to these products requires an assessment primarily of financial and protection needs. This necessitates an analysis related to death benefit, cash values, tax considerations and costs. In each situation, the issuing insurance company is involved in determining the appropriateness of the product for the customer as it relates to risk selection and general suitability.

In addition to the Commission's and FINRA's roles in the registration and sales of these products, the products are also regulated by state insurance commissions. Insurance producers/registered representatives who sell these products are subject to supervision by an SEC/FINRA-regulated broker-dealer and also subject to the terms of their contract with the issuing insurance company, which is subject to regulation by multiple state insurance regulators. Indeed, the scope and level of regulation is significantly higher for variable life insurance products than for other securities under the existing standard of care. We discuss the business of our members and the regulatory requirements specific to the sale of variable products in more detail in Attachment B to this letter.

The detailed rules and multiple layers of supervision and oversight applicable to the broker-dealer regulatory regime are far more robust in protecting investors than the investment adviser regulatory regime.

Advocates for the enactment of Section 913 and implementing SEC rules have focused upon the issue of whether the standard of conduct for brokers and dealers should be "raised" to the fiduciary duty standard under the Advisers Act. However, the Commission is well aware of the more rigorous regulatory regime applicable to broker-dealers versus investment advisers and, indeed, the Release identifies a number of key areas where the broker-dealer regulatory regime is far more robust.[21]

[20] *See generally* AALU-SEC Letter, *supra* note 4.

[21] Release at 14,862-63.

To begin, while broker-dealers are regulated by the SEC, FINRA, and state securities regulators, investment advisers with less than $100 million in assets under management – those most likely to serve smaller customers – are subject only to state regulation and inspection. Even for those who register with the SEC, there is no assessment by the SEC or any other regulator as to whether the investment adviser has a credible business, has adequate controls in place, or is qualified to advise investors concerning securities. If the adviser completes the required Form ADV and is not a felon or subject to other statutory disqualifications, then the applying individual or firm will be approved for registration. Here it is important to note that 40% of all investment advisers registered with the SEC have never been subject to an inspection; indeed, only eight percent of the investment advisers registered with the SEC are inspected each year.[22] While registered representatives of broker-dealers are subject to requirements for training and continuing education, investment advisers are not. In each of these, as well as other, areas, the regulatory and oversight regime applicable to broker-dealers is far more robust in protecting investors than the investment adviser regime.

We believe the focus on a uniform standard of conduct is an unfortunate diversion from what should be a more important priority for the Commission: addressing the gaping disparity in regulatory oversight and inspections of broker-dealers and investment advisers. Some of the most dramatic failures in the regulation of the retail brokerage/investment adviser marketplace have not stemmed from a lack of rules governing financial professionals or the lack of a fiduciary duty of malefactors, but rather a failure of regulatory oversight.[23] We believe few investors understand the significant disparity between the oversight of broker-dealers and oversight of investment advisers. Broker-dealers, as compared to investment advisers, also employ significantly more internal resources, programs and procedures to comply with their responsibilities under Commission and FINRA rules. We also believe this difference in internal supervision and regulatory diligence is unknown to most investors, who arguably would express concern if surveyed on this point. The level of internal broker-dealer resources committed to compliance, together with the industry's financial support of FINRA for its oversight of broker-dealers, is a significant multiple of government and private sector resources devoted to compliance on the investment adviser side.

---

[22] SEC, Fiscal Year 2014 Cong. Budget Justification (2013), *available at*: http://www.sec.gov/about/reports/secfy14congbudgjust.shtml.

[23] *See, e.g.*, *SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme,* SEC Press Release 2008-293 (Dec. 11, 2008), *available at*: http://www.sec.gov/news/press/2008/2008-293.htm (including the SEC complaint and orders referenced therein); *see also SEC Charges R. Allen Stanford, Stanford International Bank for Multi-Billion Dollar Investment Scheme,* SEC Press Release 2009-26 (Feb. 17, 2009), *available at*: http://www.sec.gov/news/press/2009/2009-26.htm (including the SEC complaint and Litigation Release No. 20901 referenced therein); David Stout, *Report Details How Madoff's Web Ensnared S.E.C.*, N.Y.TIMES (Sept. 2, 2009), http://www.nytimes.com/2009/09/03/business/03madoff.html; Zachary A. Goldfarb, *SEC Suspected R. Allen Stanford of Ponzi Scheme 12 Years Earlier, Report Says*, WASH. POST (Apr. 17, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/04/16/AR2010041604891.html.

No standard of care is effective without a mechanism to monitor and enforce its application. The Commission and other regulators and self-regulatory organizations already devote the clear majority of their oversight and inspection resources to broker-dealers. An investment adviser who is compensated based on assets under management can be just as likely to make an inappropriate recommendation to garner more assets as any commission-based broker. Devoting limited Commission resources to imposing a uniform standard of conduct for brokers, dealers and investment advisers should be considered only if and when the oversight, inspection, and supervision gap between broker-dealers and investment advisers is sufficiently addressed.

The imposition of a new "best interest" standard for broker-dealers would provide no increase in investor protection but would increase costs, increase potential liability, and reduce the products and services available to investors.

Although under certain circumstances (such as when a broker has discretionary authority over a customer's account) a broker may be held to the legal standard of a "fiduciary," we believe Advisers Act regulation or a broad fiduciary duty standard would provide no measurable increase in investor protection for retail customers of broker-dealers, while it is likely to increase costs, increase liability, and reduce products and services provided by our members.

The fiduciary duty of investment advisers to their customers has developed over time, through case law under the Investment Advisers Act, and also in accordance with principles articulated under the Uniform Prudent Investor Act ("UPIA"),[24] which has been adopted in 44 States (the remaining states have adopted parts of the UPIA, but not the entire act). In practice, investment advisers work with the clients to establish a written plan for the investment of assets called an Investment Policy Statement ("IPS"). The IPS outlines the general investment goals and objectives of a client and describes the strategies the investment adviser's representative ("IAR") may use to select and monitor assets for adherence to the investment plan. The IPS also commonly details the responsibilities of each party and is supplemented by disclosure of fee structure. In preparation of such a document, the adviser is required to assess the unique financial situation of the client, taking into account his or her current investment portfolio, need for income, tax status and bracket, inflation, client goals, economic environment, investment objectives, risk tolerance and how individual investment recommendations fit into the overall portfolio.

This process of meeting with a client to gather information on current assets and information on the client's unique factors establishes goals based on the articulated factors: presenting a plan, drafting an investment policy statement and then recommending assets that conform to the investment policy statement. This typically takes three to four meetings and a minimum of 10 to 15 hours of time upfront. With the investment policy statement, the review of

---

[24] Drafted by the National Conference of Commissioners on Uniform State Laws and adopted by the American Bar Association, the UPIA builds upon previously principles of prudent trust investment management. *See* Restatement (Third) of Trusts §§ 90-92 (2007).

the recommended assets at that time is relatively simple, because they tend toward no-load mutual funds, exchange traded funds, stocks and bonds that either match or do not match the asset classes of the investment policy statement.

FINRA and the SEC use a rules–based approach to enforcing the antifraud provisions and the just and equitable principals of fair dealing enumerated in the Securities Act and the Securities Exchange Act. An important aspect of fair dealing is the obligation that registered representatives make investment recommendations which are suitable and consistent with the interests of the customer. FINRA rules 2090 and 2111 collectively require the registered representative to obtain certain essential facts concerning every customer and to use that information in reasonably determining whether an investment product or strategy is suitable prior to making an investment recommendation. When a sale of securities is executed, broker-dealers are paid a commission from the product sponsor, mutual fund or insurance company, instead of a fee by the client. The broker-dealer has responsibility for reviewing the offering of the product and having a separate determination of suitability by a registered principal of the firm.

If a new fiduciary standard is imposed on broker-dealers, as the Commission has outlined in the Release, registered representatives and broker-dealers would have to meet both current FINRA requirements and any requirements under the newly imposed uniform fiduciary standard. In order to comply with a "best interest" test, registered representatives would most likely need to gather significantly more information from the client and draft the equivalent of an investment policy statement for each transaction, including even the most basic trades and product sales, in order to satisfy this test. How else could a broker-dealer truly determine what is in the client's "best" interest, unless the broker has far more documentation and information about the client and far more information about possible alternatives to the product recommended by the broker-dealer? If the Commission does not intend this result, then it should state in the Release that the fiduciary duty it would apply to broker-dealers does not require the development of an investment policy-type review or an analysis of alternatives to the recommended investment.

Indeed, unlike the advisor model where the recommendation of assets conforming to the investment policy statement is simple, broker-dealers would also face a new and very burdensome duty to not only look at recommendations to see if they match the investment policy statement, but they would also have a duty to consider all alternatives that could possibly be recommended, which of these alternatives results in a lower cost, and specific features of not just the recommended products but other assets that could be offered.

Our members have a long history of being able to determine suitability. However, determining what is "best" would be a highly subjective determination, opening a producer to second-guessing and liability, often years after the sale of a product. For example, is the best product in a rising market the one that is most aggressively allocated to equities? The best product for the client that dies three years into the contract would be the one with the highest death benefit. In a prolonged depressed equity market, the product with the best income guarantee would clearly be the most favorable to the client. One product may have fewer investment choices and lower costs; another may come with higher charges but a wider range of investment choices. Thus, we believe the imposition of a broad new "best interest" or fiduciary duty standard inevitably will lead to uncertainty, second-guessing, and increased litigation – all without delivering on the promise of reduced investor confusion

Our members believe there would be a significant increase in costs and complexities for broker-dealers in attempting to comply with both the FINRA rules and the additional layer of a principals-based approach under a fiduciary standard. As discussed below, two members of AALU's Regulatory Reform Committee and Regulatory Task Force have attempted to estimate these costs, based on their comparative experiences running both broker-dealers and investment advisers in their firms.[25]

One member, a full service broker-dealer and registered investment adviser, provides access and support to insurance producers for a broad range of investment products, platforms and partners, with broker-dealer services accounting for about 80% of its business. It estimates that, if the Commission adopted rules providing for full harmonization – falling both on the broker-dealer and investment adviser firms – it would see an increase in costs (related to financials, operations, risk & compliance, supervision, products, registration and licensing, and education) of 65% to 75%. If the Commission focuses primarily on the adoption of the fiduciary duty described in the Release, the costs would fall much more heavily on the broker-dealer.

For example, it estimates a 250% increase in costs allocated to "operations," which would include support for changes such as account opening paperwork, client information review and verification, and increased customer and regulatory communications. It estimates that costs related to risk and compliance oversight will increase 40% to 50%. These costs, including additional staff needs, will result from anticipated changes in additional client disclosure documentation, advertising and sales literature review, joint case work and the written agreements that provide the supervision and oversight of those relationships. Testing and audits for risk review and compliance oversight will have expanded requirements under a new fiduciary standard, and the additional requirements will impact the amount of staff time required.

It is anticipated that a new fiduciary standard will increase the frequency of legal matters associated with expanded customer litigation and arbitration. The time and resources required to defend and work through the facts and circumstances of increased legal matters is estimated to increase legal costs by 40-50%. This member also anticipates that increased customer claims, both in the number of claims brought and the frequency of claims, under a new fiduciary standard will increase errors and omissions insurance costs by an estimated 40-50%. This increase is attributed to additional staff focus and increased premiums to cover losses brought by customer claims. It estimates that a new fiduciary standard will increase regulatory costs by 25-50%, because of the additional staff time and higher probability of regulatory actions due to new requirements, and lengthy resolutions that could involve more regulatory enforcement questions.

Another significant element of increased costs is supervision. With a new fiduciary standard it is estimated that costs around the supervision of business will increase by 80-100%. The increase in costs are attributed to additional requirements and staff support as it relates to

[25] These members would be pleased to meet with the staff to share their calculations and discuss each element of estimated costs.

changes in the documentation and supervision around customer relationships, both new and existing. Specifically, time and resources needed for product review, supervision of transactions and strategies, customer correspondence and email review, and financial plans will increase substantially. Product costs could increase by 150-175% with the additional staff and resources needed to address due diligence procedures, review of product complexity, and the analysis of "best" products under a new fiduciary standard. Of course, any new standard will require additional training and education, estimated to result in a 25-50% increase in costs in these areas.

Another member, a full-service broker-dealer and investment adviser, calculated current compliance costs allocated to the broker and the adviser, based on assets under management and customer account size. Its findings confirmed the concerns that AALU and others have been raising with the Commission for the past three years. It determined its compliance costs per new account are three times as much in the broker-dealer versus the investment adviser, even though the broker-dealer customer average account size is half as large as the average account at the investment adviser. This member calculates that, if the SEC adopts its proposed uniform fiduciary standard, its legal, compliance, and supervision costs would rise 50-100%.

This member also provided a list of recent regulatory examinations. Since 2004, its broker-dealer has been inspected six times by the SEC or FINRA, with an average of almost three weeks on site and, for three of the FINRA exams, many months of follow up. During that period, the adviser was inspected by the SEC only twice, with a week on site each time and several months of follow up for one visit. Since the SEC continues to be the only regulator for investment advisors meeting its threshold for assets under management, it is likely that the burden of regulatory examinations will continue to be borne much more heavily by broker-dealers than investment advisers.

Unfortunately, advocates for a fiduciary standard have framed the issue in emotional terms: How could anyone oppose requiring a broker to act in a customer's "best interest." But, the reality is that this general phrase must be applied in the context of securities laws and rules, which specify brokers' conduct and provide a framework for those who supervise them.

AALU believes the most costly outcome of the imposition of the proposed fiduciary standard on broker-dealers would be the harm inflicted on consumers in the form of higher fees, the loss of access to financial professionals, and reduced choice of products.

- The broker-dealers that attempt to continue serving middle and lower net worth clients would likely respond by reducing the number and types of products offered to those customers, in an attempt to reduce the complexity of the review process and avoid being judged subjectively after the fact, by offering a product that was not in the client's "best interest."

- Because the burden would be felt by broker-dealers (unless the Commission truly would harmonize regulatory burdens by bringing investment advisers under the more robust broker-dealer requirements mentioned in this letter), it would also result in government regulation that favors investment advisors over broker-dealers, creating unintended regulatory arbitrage.

- It would also likely result in much less professional advice to clients who are unwilling to pay fees, go through a more lengthy process, and have less than $250,000 to invest. It is also likely that broker-dealers will be hard pressed to offer innovative product sets, particularly insurance-based products like variable life and variable annuities.

- Another unintended consequence is that a number of registered representatives could likely drop FINRA registration. There would likely be an increase in non-registered investment offerings, and clients would be offered only general account life insurance products, with no option of separate account products. In essence, this would push many middle and lower net worth clients to product sets that are less regulated and offer fewer benefits.

- The consequences of increased costs and reduced distribution would be a reduction in capital formation, efficiency, and competition.

We believe the above consequences not only are harmful, but also unnecessary. The Commission, on its own or working through FINRA, has it within its discretion the tools to address whatever harm it believes occurs as a result of customer confusion, by developing rules for clear and concise disclosure about roles and conflicts by those providing investment advice to retail customers. A uniform fiduciary duty cannot both accommodate the business models of broker-dealers *and* satisfy investment advisers, who believe "uniformity" means an Investment Advisers Act-type standard of care but are unwilling to accept more rigorous FINRA-type requirements in areas such as prior review of business before registration, examination scope and frequency, advertising, training and education, and supervision.

AALU appreciates the opportunity to submit these comments to help inform the Commission.

Sincerely,

David J. Stertzer
Chief Executive Officer

cc: The Honorable Mary Jo White, Chairman
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Daniel M. Gallagher, Commissioner

Attachment A
Sample Disclosure Form - Roles, Responsibilities, Products and Conflicts

Explaining the differences between Insurance, Broker Dealer and Investment Advisory Services

INDEPENDENT CONTRACTOR RELATIONSHIP WITH ACME

As an independent financial professional, I am able to work with my clients to determine the services that are most appropriate given their goals and circumstances. Based on the services you request, I work through various ACME companies (described in this document), to fulfill your risk management and wealth management needs in my capacity as an insurance agent (insurance services), as a registered representative (brokerage services), as an investment adviser representative (advisory services), or any combination of these roles.

I am affiliated with the ACME companies (also collectively referred to as "ACME") in the following ways:

- I & REP COMPANY NAME are contracted through ACME Insurance Agency, Inc. to provide fixed (general account) life insurance and annuity products that are regulated by state insurance departments.
- I am also a Registered Representative of ACME Securities, Inc., a national, introducing broker-dealer, registered with the Financial Industry Regulatory Authority (FINRA) and the U.S. Securities and Exchange Commission (SEC). When selling securities products, I sell these products through the broker-dealer. These products include variable life insurance and annuity products offered by life insurance companies.
- I am also an Investment Advisor Representative of ACME Advisers, Inc., registered with the SEC.

I am not an employee of ACME companies; I am an independent contractor and have chosen to affiliate with the ACME companies to offer certain financial products through them to my clients. REP COMPANY NAME is likewise not owned or controlled by ACME. As independent contractors, we pay all of our own expenses including staffing, rent, medical and retirement benefits.

It is important to understand that insurance, securities and investment advisory services are separate and distinct and each is governed by different laws, legal standards and separate contracts with you. While there are similarities, depending on the capacity in which we act, our contractual relationship and legal duties to you are subject to a number of important differences. I encourage you to review this information carefully and discuss it with me further if you have any questions.

INSURANCE SERVICES DISCLOSURES

INSURANCE PROFESSIONAL SERVICES:
I am licensed with certain state departments of insurance and appointed with several insurance companies to offer a wide variety of insurance products such as life insurance, disability insurance, long-term care insurance, annuity products and group insurance.

When I serve as an insurance agent, my compensation is exclusively in the form of commissions, and bonuses (which could be cash or non-cash arrangements such as travel) paid to me directly by the insurance carrier or through ACME Insurance Agency, Inc. While I am under no obligation to sell any specific company's products, I have agreed to minimum production requirements, in aggregate, to maintain a relationship with ACME's preferred insurance carriers. ACME's contracts and purchasing power with these carriers may allow us to purchase insurance products at better terms for our clients and also may lead to higher compensation paid on business with certain carriers than other carriers that we may work with through other relationships.

BROKER-DEALER SERVICES DISCLOSURES

BROKER-DEALER SERVICES:
As an introducing broker-dealer, ACME Securities, Inc. is able to take customer orders and execute securities transactions either by you writing a check to an insurance company, mutual fund company, or other investment company directly, or by you establishing a brokerage account and making deposits to our clearing firm, WIDGETS LLC.

I can assist clients in meeting overall investment needs and goals and implementing investment strategies that are designed to pursue those investment goals. I am also able to make recommendations to brokerage clients about whether to buy, sell or hold securities such as stocks, bonds or mutual funds.

However, I will only buy or sell securities upon specific directions from you. ACME Securities, Inc. does not allow me, as a registered representative, to have the discretion to make investment decisions on your behalf.

- Recommendations made are considered to be part of our brokerage services and no separate fee is charged for this advice.
- Recommendations must be suitable for each client in light of the client's particular financial circumstances, goals and tolerance for risk.

VARIABLE LIFE AND ANNUITY PRODUCTS:
Variable life insurance and annuity products are regulated by state insurance/securities departments, by FINRA and the SEC (an overlap of insurance and broker-dealer regulatory structures). These products are filed with the SEC and require a prospectus, which contains information on costs and risks associated with the investment. These products are regulated as securities because they offer clients investment choices in sub-accounts that contain securities. When these products are recommended to the client, we are acting in the capacity of a broker-dealer. Compensation is in the form of commissions and bonuses similar to fixed (general account) life insurance products. These transactions are supervised by ACME Securities, Inc. and must be deemed suitable for the client, based on information you provide.

COMPENSATION, CHARGES AND POSSIBLE CONFLICTS:
If you choose to establish a brokerage account with us, you will pay a commission for our brokerage services each time we execute a transaction for your account. In the case of variable life and annuities, ACME Securities, Inc. will be paid a commission by the insurance company that issued the policy. ACME Securities, Inc. pays a large portion of the commission it receives to me as a registered representative of the broker-dealer.

While I am under no obligation to recommend any specific company's products, I have agreed to minimum production requirements, in aggregate, to maintain a relationship with ACME Securities, Inc.'s preferred insurance companies. ACME Securities contracts and purchasing power may allow us to purchase products at better terms for our clients and may lead to higher compensation paid on business with certain insurance carriers than other carriers that we may work with through other relationships.

In addition to the full disclosure of all charges for specific products which can be found in the prospectus, further details about specific brokerage service pricing and special compensation arrangements that ACME Securities has with issuers may be found by visiting our website at the following link ______________ or will be provided to you at your written request.

ROLE & RESPONSIBILITY AS YOUR BROKER DEALER:
When I act as your broker for securities transactions, ACME Securities, Inc. and I are held to the legal standards of the Securities Exchange Act of 1934, the Securities Act of 1933, the rules of self-regulatory organizations such as FINRA and state laws where applicable, which include:

- As your broker and broker-dealer, ACME Securities, Inc. and I have a duty to deal fairly with you.
- We must have a reasonable basis for believing that any securities recommendations we make to you are suitable and appropriate for you, given your individual financial circumstances, needs and goals as disclosed to us by you.
- A registered principal of ACME Securities, Inc. must also review the recommendations I have made and evaluate whether or not they are suitable.
- Consistent with our duty of fairness, we are obligated to make sure that the prices you receive when we execute transactions for you are reasonable and fair in light of prevailing market conditions.

When we act as your broker, we do not enter into a fiduciary relationship with you, as we do when providing investment advisory services. Our legal obligations to disclose detailed information to you about the nature and scope of our business, fees, and conflicts between our interests and your interests is different than when we have fiduciary duties with you as described further in our Advisory Services Disclosures.

INSURANCE AND BROKERAGE SERVICES ADDITIONAL DISCLOSURES

ACME Insurance Agency, Inc. and ACME Securities, Inc. have contracts with certain insurance companies to have access to products, expertise and systems, and maintain purchasing power with these carriers for our clients. We have also agreed to perform certain services in lieu of insurance company employees performing those services, including gathering all medical information. As a result of direct contracts and a large volume of business with these select insurance companies, there may be higher compensation paid by these carriers to us than ones that we work with through other relationships. These carriers will reimburse ACME companies for medical exams, lab work and the costs of gathering medical records. In addition, select carriers may subsidize software, training, meetings, and trips and other benefits, but the value of these items in total does not exceed 5% of total compensation.

ADVISORY SERVICES DISCLOSURES

INVESTMENT ADVISORY SERVICES:
I may offer a number of investment advisory services to clients, acting in the capacity of an investment adviser representative of ACME Advisers, Inc. Services may include comprehensive financial planning, limited discretionary investment advisory programs, and advice on the selection of investment managers and mutual funds offered through our investment advisory programs.

When we act as your investment adviser, we will enter into a written agreement with you expressly acknowledging our investment advisory relationship with you and describing our obligations to you. At the beginning of our advisory relationship, we will give you our Form ADV Part 2A and Part 2B brochure(s) that provide detailed information about, among other things, the advisory services we provide, our fees, our code of ethics, our other business activities and financial industry affiliations and any conflicts between our interests and your interests. This information can also be found at the following link_______________

CHARGES FOR INVESTMENT ADVISORY SERVICES:
For asset management accounts ACME Advisors will charge you an annual fee which you will authorize to be withdrawn from your account on a quarterly basis. These fees are based on a percentage of assets held in your advisory account. For consulting services, fees for services will be negotiated with me and documented in the advisory contract. ACME Advisers will pay me a large portion of the fees that you pay directly or authorize to be withdrawn from your account.

FIDUCIARY ROLE & RESPONSIBILITIES AS AN INVESTMENT ADVISER:
As a registered investment adviser, ACME Advisers, Inc. and I are considered to have a fiduciary relationship with you. We are held to legal standards under the Investment Advisers Act of 1940 and state laws, where applicable, that reflect these standards, which include:

- Obligations to disclose to you all material conflicts between our interests and your interests.
- If we or our affiliates receive additional compensation from you or a third-party as a result of our relationship with you, we must disclose that to you.
- We must obtain your informed consent before engaging in transactions with you when we act in an advisory capacity.
- We must treat you and our other advisory clients fairly and equitably and cannot unfairly advantage one client to the disadvantage of another.
- The investment decisions or recommendations we make for you must be suitable and appropriate for you and consistent

with your investment objectives and goals and any restrictions you have placed on us.

- It is important to note that there may be limitations on damages you may recover against us as an advisor, such as damages being limited to amount equal to fees paid.

FOR MORE INFORMATION

Ensuring that you understand the various roles in which I may deliver various financial products to you is important to me. The insurance, brokerage and advisory services we offer differ in ways other than those summarized in this document. Therefore, it is important you carefully read all agreements and disclosures provided to you with respect to the specific products or services under consideration.

While we strive to make sure the nature of our services is clear, if you need information beyond the disclosure provided here, links to the website, information contained in prospectuses, or the form ADVII, we welcome your questions. You can either direct these to me as your financial professional or request information in writing or via email.

For more information, visit us at www.acmesecurities.com

By signing below, I, ______________, acknowledge that, NAME HERE REP NAME has reviewed with me the various roles in which he/she may serve and given me an opportunity to seek additional information about the nature of the services and potential conflicts of these roles.

CLIENT NAME DATE

____ __________________

Attachment B

AALU Members, Their Business, and the Regulations Under Which They Operate

AALU members are engaged primarily in sales of life insurance used as part of estate, charitable, retirement, deferred compensation and employee benefit services. Some of our members sell life insurance primarily to business clients to finance and secure employee benefits. However, many of our members work primarily with individuals, who often retain attorneys, accountants, and other professionals to assist in developing products and services for their long-term life insurance protection and retirement needs. Many of our members offer variable life insurance and variable annuities. These bundled products offer investment choices with separate guarantees from the issuer such as a guaranteed death benefit and lifetime income guarantees, which are important options for many of our customers seeking to address their life insurance protection and retirement needs.

Other than "associate" members who are non-sales professionals such as attorneys, accountants and actuaries, all of our members are licensed insurance producers. Many are registered representatives of an SEC/FINRA-registered broker-dealer, and many also are associated persons of an SEC-registered investment adviser, and therefore are subject to both the broker-dealer and investment adviser regulatory regimes. Many of our members own their own insurance agencies. Some of these agencies own or are affiliated with registered broker-dealers or investment advisers. Thus, our members are subject to the state insurance laws of each state in which they operate.[1] Those who sell registered products are, in addition, subject to SEC, FINRA, and state securities regulation in multiple states. Those who operate or are associated persons of registered investment advisers are subject to SEC regulation of investment advisers.

Many of our members have served the same individual clients and their families for decades. Our customers are of primary importance to us and, for that reason, we work closely with them to understand their needs and objectives in connection with the insurance and investment products we are authorized to sell, within the framework of our contracts with carriers and other obligations under all of the laws and regulations to which we are subject.

Our obligations under state insurance laws.

AALU members typically represent at least one and often a number of life insurance companies ("Carriers") and have multiple state insurance practices and licenses. Carriers set the policy provisions and costs of life insurance products sold by AALU members and other producers, and these products are filed and approved by the respective state insurance commissioners.

[1] Many of our members are licensed in more than half of the 50 states.

Life insurance producers must meet applicable standards, requirements and safeguards in every state in which they sell life insurance.[2] While each state has its own set of laws in this area, the National Association of Insurance Commissioners ("NAIC") has brought significant uniformity to the various state laws. The NAIC and the states continuously work to develop and enhance regulation to meet the needs of insurance consumers, in light of new developments in the marketplace for insurance products and other products sold by licensed insurance producers. States typically adopt all or key portions of model laws developed by the NAIC.

State insurance laws typically regulate the activities of both insurance companies and producers. They protect the interests of life insurance consumers in a number of critical ways. Every state law requires minimum levels of competency for producers by requiring that they pass a test, answer background check questions as part of the application process, and obtain a license prior to selling, soliciting, or negotiating life insurance and annuity products. Many states require producers to complete pre-licensing education. All states require insurance producers to complete ongoing continuing education to maintain their licenses.[3] Some states mandate training in specific products that have particular risks associated with them. As part of licensing, state insurance commissioners must determine that the producer is competent, trustworthy, financially responsible and of good personal and business reputation. Commissioners have broad discretion to revoke licenses based upon violations of insurance law or financial dishonesty.

States also have widely adopted a version of the NAIC Model Unfair Trade Practices Act,[4] which gives insurance commissioners authority to revoke a producer's insurance license and issue cease and desist orders for estimates, illustrations, circulars or statements, sales misrepresentations, omissions or comparisons which misrepresent the benefits, advantages, terms or conditions of a life insurance or annuity contract. Another model law, the NAIC Insurance and Annuities Replacement Model Regulation,[5] establishes protections for consumers through required systems of supervision, control, monitoring, and recordkeeping for insurers and producers. Most states have adopted a version of the NAIC Suitability in Annuity Transaction Model Regulation,[6] which is designed to ensure that annuity transactions address insurance and

[2] *See* Letter from Sandy Praeger, Roger A. Seveigny, Jane L. Cline, and Susan E. Voss, NAIC Officers, to Christopher Cox, Chairman, SEC, File No. S7-14-08 (Sept. 10, 2008), *available at*: http://www.sec.gov/comments/s7-14-08/s71408-1712.pdf.

[3] The NAIC Uniform Licensing Standards require 24 hours of continuing education for all major lines of authority on a biannual basis, and many states' requirements are based upon this model. *See* NAIC, *Revisions and Clarifications to the Uniform Licensing Standards* (Dec. 2008) (as adopted by the Producer Licensing Working Group and the NAIC D Committee), *available at*: http://www.naic.org/documents/committees_ex_pltf_plwg_uniformity_stds_wclar.pdf.

[4] Unfair Trade Practices Act, NAIC Model Regulation Service at 880-1 (Jan. 2004), *available at*: http://www.naic.org/store/free/MDL-880.pdf.

[5] Insurance and Annuities Replacement Model Regulation, NAIC Model Regulation Service at IV-613-1 (Oct. 2007), *available at*: http://www.naic.org/store/free/MDL-613.pdf.

[6] Suitability in Annuity Transactions Model Regulation, NAIC Model Regulation Service at II-275-1 (Apr. 2010), *available at*: http://www.naic.org/store/free/MDL-275.pdf.

financial objectives of consumers by imposing suitability standards and duties for life insurance companies supervising and detecting unsuitable sales. Many states have adopted a version of the NAIC Annuity Disclosure Model Regulation[7] to provide standards for the disclosure of certain minimum information about annuity contracts to protect consumers and foster consumer education. In addition, states have widely adopted a version of the NAIC Model Law on Examinations,[8] which sets forth clear guidelines for state insurance commissioners to schedule and conduct effective and efficient market conduct examinations of the activities, operations, and financial conditions of those who sell life insurance products.

It is important that the Commission recognize the breadth and effectiveness of these state laws, many of which address the same issues of customer protection (e.g., requirements for full disclosure about the risks of the products being sold; regulation of sales practices by the financial professionals who sell them; training, supervision, and auditing of those financial professionals) addressed under Exchange Act and FINRA regulation.

As the NAIC testified before the Senate Banking Committee in early 2009, consumer protection is a critical focus for State insurance regulators, who have a keen understanding of the unique nature of insurance products:

> Consumer protection has been, is, and will remain priority one for State insurance regulators. State insurance supervision has a long history of aggressive consumer protection, and is well-suited to the local nature of risk and the unique services offered by the insurance industry. State regulators live and work in the communities they serve, and respond accordingly.…Insurance is a uniquely personal and complex product that differs fundamentally from other financial services, such as banking and securities….State officials have responded quickly and fashioned effective remedies to respond to local conditions in the areas of claims handling, underwriting, pricing, and market practices.[9]

Our contractual obligations to the carriers who appoint us.

In the sale of insurance products, our members are appointed by carriers pursuant to producer contracts that specify, in detail, the producer's duties and obligations to the carrier.[10]

---

[7] Annuity Disclosure Model Regulation, NAIC Model Regulation Service at II-245-1 (Oct. 2011), *available at*: http://www.naic.org/store/free/MDL-245.pdf.

[8] Model Law on Examinations, NAIC Model Regulation Service at III-390-1 (Oct. 1999), *available at*: http://www.naic.org/store/free/MDL-390.pdf.

[9] *Perspectives on Modernizing Insurance Regulation: Hearing before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 11 (2009) (testimony of Michael McRaith, Director of Insurance, Illinois Department of Financial and Professional Regulation, on behalf of the NAIC), *available at*: http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=9d32d178-0b51-415d-989d-8bd87d6477e0.

[10] In general, the carrier must file a notice with the state insurance department regarding the appointment of the producer to sell its products and any termination of the producer.

These contracts vary among carriers, but typically may include, among other things, the producer's responsibilities to (1) treat money and applications as property held in trust; (2) comply with the carrier's underwriting and issue requirements and all applicable insurance laws and regulations of the jurisdictions in which the producer operates, including laws and regulations pertaining to client funds, confidentiality, licensing, rebating, replacements, illustrations, solicitation, and advertising; (3) comply with the carrier's rules and procedures regarding the sale of products and delivery and servicing of policies; (4) inform the carrier of all material facts of which a producer is aware relating to the insured or proposed insured prior to issuance and delivery of policies; (5) train and supervise a producer's employees, agents, and representatives; (6) solicit and submit only authorized products; and (7) immediately notify the carrier of any customer complaint.

These contracts generally require further representations and warranties by the producer, including that the producer will comply with licensing and other requirements of the jurisdictions in which the producer operates, as well as with the carrier's own rules and processes relating to market conduct and other activity. Failure to comply with any of these requirements may result in the termination of a producer's appointment by the carrier. Producer contractual obligations to carriers are designed to help ensure compliance with laws and rules which are designed to protect life insurance product purchasers and policyholders.

The carrier is regulated and audited by state insurance regulators in each of the states in which it operates. While information concerning the scope and detail of these audits may be best obtained from the carriers, they often involve examinations of market conduct, focusing on the carrier's records and files concerning producers who are appointed to sell the carrier's products.

With respect to the sale of variable life insurance and variable annuities, the carrier's contract may involve multiple parties (e.g., the distributor, a broker/dealer registered with the Commission and a member of FINRA, and the insurance agency) and the carrier typically enters an agreement with the broker/dealer and those persons associated with the agency who are FINRA registered representatives of the broker/dealer and state insurance licensed agents of the carrier to solicit and procure applications. Pursuant to the contract, the broker/dealer makes numerous representations, including, among others, (1) that it is registered with the Commission and a member of FINRA; (2) that the broker/dealer will ensure that no registered representative will sell or recommend for sale any contract without reasonable grounds for believing, after appropriate inquiry, that the purchase of a contract is suitable for that person (and other requirements under FINRA rules); (3) that the broker/dealer agrees to provide the carrier with annual certification as to compliance with applicable state laws; and (4) that the broker/dealer has implemented a training program for its affiliated registered representatives in specified areas.

The unique nature and regulation of variable products sold by insurance producers; our obligations under state insurance laws and SEC/FINRA regulation.

AALU members often offer clients a choice of life insurance products, including fixed and variable life. In evaluating and planning for death benefits, many clients also seek to obtain certain guaranteed retirement benefits, and, therefore, fixed and variable annuities are an important adjunct to the other life insurance products offered by producers. In addition to regulation at the producer/registered representative level, variable products are subject to a very high level of disclosure through the prospectus that each client receives, which contains a detailed disclosure of how the product works and all charges to the contract. The disclosure includes not only explicit sales charges but also all other related costs of the policy. Every penny of investor money must be accounted for in confirmation statements itemizing all charges associated with the policy premium. Producers selling these products are subject to regulation by state insurance regulators, the SEC, FINRA, and state securities regulators.

Sales of variable life.

Although treated as a security under the securities laws, a variable life insurance policy is, like a fixed life insurance product, first and foremost a contract that pays a death benefit to the insured's beneficiaries in the event of an untimely death. From an insurance law perspective, the primary interest of the client must be to purchase a policy that is suited to his or her individual insurance needs. That in turn requires careful and thorough medical and/or financial underwriting of the particular individual, after gathering detailed information from the client. This is a lengthy process, ranging from 30 to up to 180 days, during which there are multiple points at which the client and the client's other advisors have the opportunity to consider various aspects of the transaction.

Underwriting of medical/non-medical risk factors is almost always required when obtaining bids from one or more carriers for a life insurance policy. Medical underwriting evaluates the current and prospective health of the insured, and assesses the probability of when the insurance company may be required to pay death benefit proceeds to the insured's beneficiaries, based upon the collected medical information and any non-medical risk factors. This assessment sustains the initial carrier decision whether to deny coverage, offer coverage at various defined risk classifications, or offer coverage subject to certain restrictions.

As part of this process, the producer helps the client determine the appropriate death benefit based upon a detailed and thorough "needs analysis" which, for a person seeking to replace his or her income for surviving family members, would generally include analysis of information for the individual and spouse, including: annual gross income from all sources; mortgage debt and all outstanding loan and revolving credit balances and other outstanding debt; estimated routine household expenses; a calculation of final expenses (including medical costs, probate and funeral expenses); calculation of an estimated annual inflation rate; estimated liquid assets; estimated retirement assets, such as amounts in pension plans, IRAs, 401(k)s; amount of any existing life insurance coverage in place; the number of dependent children and the estimated cost of education through college for each child; and the number of years of salary the client wishes to set aside for lifestyle maintenance. The subsequent analysis would then calculate an insurance amount that is needed to cover debts, providing for children, and lifestyle maintenance. This would result in the total protection needed, from which total assets would be subtracted to determine the additional life insurance needed.

Once the appropriate death benefit has been set, and medical underwriting has judged whether coverage is available and under what conditions, the insurance agent (a registered representative) then examines potential policies from one or more carriers. The cover letter to the carrier is often used by the representative to describe in detail the background of the transaction, show how the amount of proposed insurance was calculated, and disclose and clarify unusual factors that may not be obvious in the application. Some carriers may treat certain pre-existing conditions or other factors less onerously than others and offer better pricing for the same type of policy.

Financial underwriting is often required to address the state insurance law requirement of "insurable interest"; that is, to ensure that the owner of a variable life insurance policy has a greater interest in the continued life of the insured than they would have in the insured's death. The existence of insurable interest is a legal prerequisite under state insurance law to the issuance of an insurance policy. Financial underwriting is also designed to address the issue of "loss" – whether the amount of insurance applied for is reasonable in relationship to the potential loss. Here, the underwriter looks to the purpose of the insurance, such as income replacement, estate planning, or charitable giving.

To assess both "insurable interest" and "loss," the underwriter of a life insurance policy is provided with extensive and accurate information that provides the financial justification for the amount of coverage requested. Such details would include, for instance, in the case of income replacement insurance, information regarding age of the insured, current gross annual income and current insurance in force. Insurance for purposes of estate planning would require an estate analysis, and insurance for charitable giving would require such things as documented history of giving to the named charity, such as past copies of tax returns as well as details of any volunteer work with the charity to demonstrate strength of the relationship.

A key component of financial underwriting is assessing the policy owner's sources of funding for the life insurance premium payments. In connection with this assessment, the underwriter would attempt to determine, among other things, whether a particular type of investment is being depleted to fund life insurance, whether those funds are needed (or are more likely to be needed) more for living expenses, whether the client is retired, and whether the need for liquidity is greater than the need for insurance.

Layered on top of this analysis, much of which is designed to meet the requirements of state insurance laws, as well as the carrier's underwriting requirements, is a set of comprehensive SEC/FINRA requirements for the recommendation/sale of the investment product. Among other requirements under applicable FINRA rules, a broker-dealer must have a reasonable basis to believe that each securities transaction or investment strategy involving a security recommended by a broker-dealer is "suitable" for the client based upon very specific information that the broker-dealer is required to gather from the client and maintain, regarding the client's financial status, tax status, investment experience and objectives, time horizon, liquidity needs, and risk tolerance and such other information used or considered to be reasonable in making recommendations to the client.[11] Broker-dealers are required to use diligence to learn the essential facts regarding the opening and maintenance of customer accounts. In addition, broker-

[11] *See* FINRA Rule 2090 (Know your customer); FINRA Rule 2111 (Suitability).

dealers are required to perform product due diligence before an investment product can be recommended to the broker-dealer's clients.[12]

After the initial diligence and approval, the broker-dealer is further required to monitor the approved products for continued appropriateness for the broker-dealer's clients.[13] Recommended transactions effected by a broker-dealer must be reviewed for suitability under these rules on a daily basis by a registered, qualified principal of the broker-dealer. Our members who sell these products also are covered by requirements that broker-dealers have in place systems of supervisory control designed to assure the suitability of recommended transactions and to spot unsuitable recommendations, which include both daily real-time monitoring of transactions and review of every brokerage client account not less frequently than annually.

In considering the appropriate standard of care for sales of these products, it is noteworthy that the context and motivations of the purchaser of a variable life insurance contract are very different from those of a normal retail investor. The insurance purchaser is seeking to address insurable risks of loss, often to benefit persons other than the purchaser, rather than generate a return for the purchaser. The loss being covered usually is the lost income resulting from the death of the purchaser. Variable life insurance products commonly are used in connection with tax and estate planning. The purchaser is seeking to provide a life insurance death benefit for a third party beneficiary – usually family members. The insurance element adds the expense of the mortality risk expenses, which decreases the net investment return on the securities element of the investment.

There is an element of investment management to these variable insurance products, but it is embedded within the funding vehicle for the insurance contract. The investment management of the funding vehicle is regulated under the Advisers Act, and in many cases the Investment Company Act as well (in addition to regulation under state insurance laws). The appropriateness of the recommendation of the variable insurance contract by the broker/insurance agent is regulated and supervised under suitability rules. It is a one-time time of sale review for which the FINRA rules were designed. The appropriateness of the investment

---

[12] As stated in a 2010 FINRA notice to members, a broker-dealer "that recommends a security is under a duty to conduct a reasonable investigation concerning that security and the issuer's representations about it. This duty emanates from the [broker-dealer's] 'special relationship' to the customer, and from the fact that in recommending the security, the [broker-dealer] represents to the customer 'that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation.'" FINRA Regulatory Notice 10-22 (April 2010), *available at*: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf. (citations omitted). FINRA further stated in that notice that a broker-dealer's failure to fulfill this obligation can be viewed as a violation of the anti-fraud provisions of the federal securities laws as well as of FINRA Rules 2010, 2020, and 2310. *Id.*

[13] *See New Products - NASD Recommends Best Practices for Reviewing New Products*, NASD Notice to Members 05-26 (Apr. 2005), *available at*: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p013755.pdf.

activity conducted over time within the funding vehicles is regulated under the Advisers Act, the Investment Company Act and state insurance laws (as well as federal tax laws).

Sales of variable annuities.

As noted above, variable annuities are a useful product in the portfolio of an insurance producer/registered representative. They are attractive to many clients as a means of securing sufficient retirement savings, because they can offer the opportunities provided by equity investments while providing guarantees by an insurance company that hedge against the risk of loss. FINRA's due diligence, disclosure, suitability assessment, and supervisory requirements governing the sale of variable annuities is even more expansive than its general suitability rule. FINRA Rule 2330 sets forth extensive and detailed sales practice requirements for recommended purchases or exchanges of variable annuities, including: (1) detailed information that must be provided by the registered representative to the customer regarding the investment; (2) the registered representative's thorough assessment that the particular variable annuity is suitable for the customer, based upon specified factors; (3) detailed due diligence that must be performed by the registered representative regarding the customer, including age, income, financial situation and needs, investment experience, investment objectives, intended use of the annuity, investment time horizon, liquidity needs, liquid net worth, risk tolerance, tax status, and other relevant information; (4) the requirement that the registered representative who recommends the variable annuity must promptly send a complete application package to supervisory personnel; (5) the requirement that a registered principal review and determine whether to approve the recommendation (only after making and documenting his/her own suitability analysis); (6) the requirement for enhanced supervisory procedures for variable annuity sales and exchanges; (7) specific training policies; and (8) other requirements regarding the depositing of funds prior to approval and other requirements. Nothing even approaching this level of due diligence, supervision, and standard of care exists in Commission rules governing investment advisers.

Of course, all recommendations by our members regarding securities products are reviewed by a securities principal. The broker-dealers with which they are affiliated are subject to regular and detailed inspections by the Commission, FINRA, and state securities regulators. The producer's activities in the sale of a variable product may be subject to scrutiny by all three securities regulators, as well as state insurance regulators in any market conduct examination of the carrier.

Regulation of our members as registered investment advisers.

Since most investment advisers with which our members are affiliated have assets under management above the minimum Federal/state threshold, they are subject to Commission, but not state, regulation on the investment adviser side. Our members who are RIAs or their associated persons therefore must abide by Commission rules under the Advisers Act. Our members take seriously these requirements, as well as our fiduciary duties to those customers for whom we act as investment advisers.

As the Commission is aware, in general, the management of client accounts by an investment adviser is subject to less specific regulatory requirements and processes than those applicable to broker-dealers. As the Commission also is aware, the frequency of examinations of investment advisers is much lower than for brokers and dealers.

Under Commission rules, each registered adviser must deliver to clients a written disclosure statement or "brochure" containing information about the adviser's business, including certain relationships and activities that may present conflicts with clients. Investment advisers generally are required by the Commission to manage client accounts in a manner consistent with the governing advisory agreement and investment policy statement in place between the client and the investment adviser, which may or may not specify permitted or forbidden investment classes, whether leverage is permitted, position limits or diversification requirements. Our members review the content and performance of their advisory accounts for consistency with specific portfolio requirements or prohibitions dictated by the client agreement or client instructions on an on-going basis, and periodically for consistency with general investment goals and strategies and the advisers' outlook for particular segments, investment weightings, or issuers. Investment advisers commonly centralize the portfolio selection process to some degree, in terms of segment weightings and approved investments, either through an approved list or a model portfolio, which is subject to variation to meet the particular client's account agreement terms, including investment objectives and needs.

While it is well understood that investment advisers owe a fiduciary duty to their clients, there is no specific process or set of concrete standards that must be followed by an investment adviser in managing client accounts or in reviewing the management of client accounts under the Advisers Act. In 1994, the Commission proposed codifying the implied fiduciary obligation of investment advisers in recommending and managing client advisory accounts under a "suitability" rule modeled on the NASD and MSRB suitability rules that apply to broker-dealers, but never finalized that rulemaking.

Bundled products like variable annuities and variable life products do not lend themselves to an advisory process, because of the self-contained nature of these products. Unlike individual stocks and bonds that need to be separately assembled in portfolios, variable life and annuities come pre-assembled with several investment choices and separate contractual guarantees from the issuer such as guaranteed death benefits and lifetime income guarantees.