

Variable Annuity Replacement Considerations

When replacing a variable annuity, there are a number of factors to address to ensure that the replacement enhances the client's overall investment position. Below is a list of the common factors to consider:

- **Surrender charges:** The benefits gained by the new variable annuity should offset any surrender charge incurred.
- **Suitability:** The new variable annuity should be suitable for the client with regard to his/her age, investment time horizon and financial needs including their need for liquidity. Suitability relative to the client's sub-account allocation must also be considered.
- **Investments in tax qualified accounts:** Regulators have expressed concern that clients often do not understand that the tax-deferral feature of an annuity duplicates the tax-deferral feature of a qualified plan account. Accordingly, regulators expect and Firm policy mandates, an explicit conversation between the RR and the client on this topic. Confirm that the RR has indicated that they discussed the implications of an annuity within a qualified account with the client on the Replacement Request Form.
- **Liquidity:** Due to the long-term nature and early withdrawal tax penalties involved in variable annuity products, RRs and Supervisors must consider a client's liquidity needs from both a short-term cash flow as well as mid-term funding perspective. What is the liquidity impact to the client when purchasing an immediate annuity or annuitizing cash value?
 - **Important:** In considering this issue, it should be understood that the client is already in an annuity product and to change out of the annuity product may have immediate, adverse tax consequences. However, if the annuity is within a qualified plan and exchanging the annuity would incur additional limitations on withdrawals, using another investment vehicle within the qualified account should be considered. **Therefore the sale of a VA to clients where the Contract Value is over 30% of Net Worth will require further justification.**
 - **Important: In this context, Net Worth is defined as assets minus liabilities.** This includes residence and automobiles, exclusive of any corresponding debt unsecured debt/credit cards.
- **Death Benefits:** It must be demonstrable that the death benefits in the new variable annuity enhance the client's position. These benefits should be an improvement from the previous variable annuity.
- **Enhanced features or riders:** These are only acceptable as a rationale for replacement if the enhancement provides a significant benefit to the client that is not available through the old policy and the client is willing to incur the added cost associated with the enhancement.
- **Proprietary Products:** Surrendering proprietary products from other broker-dealers to bring the assets in-house (such as when an RR joins the firm), differences in insurance company ratings and differences in liquidity features are not valid reasons for an exchange without other compelling client-driven rationales.
- **New Surrender Schedule:** If a new surrender schedule is triggered, it should not negatively impact the client position based on the investment time horizon and financial needs.
- **Performance:** If a reason for the replacement was sub-account performance, a comparison of both variable annuities' (old and new) sub-account performance from a three, five and ten year perspective must be conducted. The new variable annuity must offer the client a sub-account allocation that could not have been achieved in the old variable annuity.
- **Bonus Features:** The bonus feature is not a valid reason for a replacement and should never be used as a primary reason for an exchange. In most instances, a bonus product will

either have higher surrender charges, longer surrender periods or higher fees than an annuity product without a bonus credit. The RR must have considered whether the cost of the bonus feature (higher fees/longer CDSC periods) is offset by its benefits.

- **Solicited v. Unsolicited:** Regardless of whether the variable annuity replacement was initiated by the client or not, the RR still has the fiduciary responsibility to do what is in the best interest of the client and improve his/her overall investment position.
- **Financial Stability:** The issue of the quality rating of the insurance company may also be taken into consideration. The issue should be considered if a company has been substantially downgraded or if it is common knowledge that the company may be experiencing financial difficulty. Normally the financial strength of the insurer does not affect sub-account performance. However, it may effect the expense changes within the product and their ability to meet other contractual guarantees.
- **Greater variety of Funds/Managers:** In determining whether this rationale is appropriate, consider whether the new product has a substantially broader selection of funds and/or asset allocation classes and whether the client plans to take advantage of the increased selections immediately or has the ability to have additional diversification in the future. If the RR has not provided details of the variety of funds in Questions 4 and 5 of the Form, the FLS should request that this information be completed.
- Replacement requests that fall under the following situations will not be approved unless additional information is provided that demonstrates suitability:
 - The client is 75 years of age or older or 45 or younger
 - The surrender charge is \$1500 or greater and 3% or more of the contract value
 - The existing contract has been held less than 3 years
 - Undue concentration over 30% of **Net Worth**