

JANUARY PROFILE

EIAs and the NASD



David Macchia

In August of 2005 the National Association of Securities Dealers (NASD) issued Notice to Members #05-50, which ostensibly attempted to clarify for broker-dealers (B/D) rules that would govern when they should supervise the sale of EIAs by their registered reps. In effect, it re-ignited the long simmering debate whether EIAs should be considered securities.

Since then, speculation has ranged to extremes, from arguments that consumers deserve this kind of compliance monitoring and sales supervision to charges that the NASD is boldly trying to cut into a \$22 billion pie.

David Macchia is president and CEO of Wealth2K, a leading developer of multi-media sales presentation tools, and one of the founders of Donabue/Macchia, a Hingham, Ma. based brokerage general agency experienced in the distribution of annuities. He spoke with LIFE & Health Advisor about what he believes the implications of NTM # 05-50 will be for all of the players involved. While it is the Securities & Exchange Commission (SEC) that holds the ultimate authority to decide that,

Macchia believes that the NASD has deftly influenced the court of public opinion.

L&HA: What is the basis for the NASD's effort to regulate equity indexed annuities?

DM: The NASD is not all wet. If I am a registered rep taking a client's assets into an equity indexed product, which are manifestly complex products, it is difficult to separate that fixed product from everything else I do for the client. The broker-dealer's (B/D) liability does not stop with the securities and investment business that I transact for the client. If the client has a complaint, or if things don't work out, everything gets pulled in together. The B/D's liability does not stop with securities. For this reason, it makes sense that they should supervise EIA sales.

L&HA: But all EIA sales?

DM: The B/D would make a directive that all EIA business must be [written] inside. Many agents would now have to get re-contracted through a B/D. But these agents also write fixed annuities, or SPIAs and all of a sudden this business is going through the B/D as well. Insurance companies have no way to differentiate, in terms of the contracts they have with agents, one annuity type from another. So, everything would now flow through the B/D.

L&HA: Are B/Ds able to do this? Do they want this?

DM: As late as [last month] I can tell you first hand that some of the biggest B/Ds in the U.S. did not realize what I just said. Their understanding of the fixed product is incomplete. We really are talking apples and oranges. They realize that they have to ramp up their understanding of this market very quickly, and a lot of them are doing just that, but they're admitting that this market is totally foreign to them.

L&HA: What about the argument that this a money grab by the NASD, to compensate for fee- income shortfalls within the B/Ds?

DM: That was my initial reaction. This is a \$24 billion market after all. But as I talked with the principals of B/Ds, that was not evident. I found them vexed by the idea that they would have to ramp up quickly and figure out how to do this thing: how to establish approved product guidelines, how to evaluate one contract from another and how they'll set up compliance review. It just did not ring true that this was fueled by the money.

L&HA: So what is the reality of this situation?

DM: The reality is that as we speak, the NASD effectively has control of the EIA business.

L&HA: They do? How did they get it?

DM: By changing the behavior of the players in the marketplace. Their notice has caused carriers to begin to

make changes, caused B/Ds to make profound changes and altered to the registered reps' mind set. I can honestly say there is no other instance that I can recall that will invoke such profound change so quickly as this notice to members; not even when universal life came on the market, introducing interest-sensitivity to life insurance products. That process was earth shaking, but it took time to unfold. This thing is only four months old, but it is changing by the minute. The notice was issued in August and by October, firms were beginning to develop policies.

L&HA: But are there already any tangible, real changes underway?

DM: The effect of B/Ds developing guidelines for EIAs works to eliminate abusive contracts, those contracts that feature very long surrender charges, or very heavy loading, or very high commissions or very reduced liquidity. These types of contracts, that are considered very unfriendly to consumers, will not find shelf space within most B/Ds. Already, B/Ds are looking at parity with regard to compensation between variable and indexed annuities, to try to eliminate any adverse incentive to offer one over the other. Furthermore, some are taking those compensation points and putting them back into the contract.

L&HA: What about EIA sales outside of the B/Ds?

DM: There is a big challenge before them. The marketing companies, and I include mine in the mix, have to forge strategic relationships with B/Ds in order to maintain their existing relationships with registered reps, or they have to form their own B/Ds. Many are doing this so that they can go to the registered reps who have been writing EIAs through them and entice them away from their present B/Ds. Here again, this represents a sweeping change to the established order, especially at the distribution level but certainly at the company level as well. It is also very disruptive.

L&HA: What about the agent who is not a registered rep?

DM: His or her world does not really change, unless and until the SEC determines that the EIA is a security. Right now, the focal point is the registered rep, but this could impact the contractual relationships between these agents and the insurance companies they are licensed with.

L&HA: How are companies viewing this shift, where they often serve both distribution channels?

DM: They are trying to figure it out, and I think some may be in peril. It comes down to the ability to access the B/D. Some have existing relationships, some don't. One of their biggest concerns will be getting shelf space in the B/D. Some are faced with the prospect of starting up an entire new infrastructure to support a B/D channel; some will work through MGAs who can get them into the B/D and still others will choose to work with those brokers who are not registered reps, and that is still a sizable market.

L&HA: Why did this thing come to a head this year?

DM: I'm not sure that I know. We know that the NASD has been looking at this for a while, as there is a securities aspect to an EIA; the crediting methodology is based on a securities index, such as the S&P. A lot of EIAs are sold by registered reps, I would guess maybe 60 percent of the market on the high end, so there is a built in interest on that basis. But there are two significant factors that I think draws its interest. First, you are dealing with seniors, making transactions involving very large sums of money. Secondly, the contracts that you are presenting are extraordinarily complex and there is good reason to believe that neither the agents nor the consumers understand them. There is the potential for a lot of dissatisfaction and complaints.

L&HA: Is there any indication that the SEC buys that argument?

DM: I don't have any indication that that's true. But look at where the arguments lead. On the one hand you've got the Massachusetts Secretary of State challenging Investors Capital Corp., claiming that EIAs are securities and they should be supervising those sales. On the other side, the Insurance Commissioner is saying that EIAs are absolutely not securities and should not be supervised. Who's the master here?

L&HA: Who is?

DM: There is none. But at the end of the day, the big dog is the one who can change behavior, and that's the NASD.