



## Variable Annuity Sub-Accounts; a Black Hole Dangerous To Investors

By James J. Eccleston, Esq.

Recently a noted expert in the field of variable annuities wrote a disconcerting article entitled, "Sub-Accounts = Black Hole of Compliance". In his article, John Duval, Sr. discusses the suitability and supervision gap that exists with the sale of variable annuities to investors. Although most of the criticism to date has focused upon whether or not a variable annuity in and of itself is suitable for an investor, his focus is different. Duval focuses upon the selection and subsequent modifications to the selection of the variable product sub-accounts; or, put another way, the investments (often mutual funds) chosen initially and subsequently for the investor within the variable annuity.

According to Duval, there is a "black hole of compliance" in what is a giant industry. Variable annuity sales now represent a quarter to one-third of the overall business for many small and medium sized brokerage firms, and the market has grown "exponentially" as well at large brokerage houses and at investment advisory firms.

Despite this growth, Duval believes that brokerage firms overlook their supervisory responsibilities in reviewing variable annuity sub-account selections to ensure that they are suitable. He describes the problem this way:

Practically, since the [variable] contract is "held" by the insurance carrier, an exchange between sub-accounts does not show up on the "daily run" [of sales] at the branch [office] and the confirmation notices for the exchanges within sub-accounts go to the registered representatives [financial advisers] and a copy to the contract holder [the investor]. But how does the firm's branch manager, home office compliance department, or anybody, know what is taking place? And, if they do, what is their procedure for monitoring suitability for the exchange?

Perhaps more troubling, the problem also exists when the broker/dealer [brokerage firm] should be able to monitor suitability. Sometimes, even initial sub-account enrollments that don't match up with the client's new account agreement are missed or ignored by the branch manager, such as aggressive [risk] sub-accounts in a variable contract for a client whose new account agreement says "moderate" [risk tolerance]. At the time of this writing only a few [brokerage] firms have begun to address either of these problems.

As an example, Duval cites the case of an elderly widow with experience only in CDs. Initially, her financial adviser recommended three variable annuity sub-accounts, each one being a mutual fund that invested only in stocks. Those sub-accounts grew until 2000, and then suffered large losses. Her adviser then decided to roll the dice by moving all of her remaining funds to an extremely risky sub-account that invested in a mutual fund investing in over-the-counter stocks, options and futures. Duval reports that in the face of the ensuing "financial debacle", the brokerage firm attempted to defend the arbitration action by claiming that few brokerage firms in the industry had maintained a compliance system that would have been effective in detecting and preventing such abuse!

Thankfully, that soon may change. In 2004, the NASD filed with the Securities and Exchange Commission ("SEC") a proposed new Rule 2821. This proposed rule still is pending with the SEC. If the



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SEC approves the new rule, it would require brokerage firms to determine that the recommendation of the underlying sub-accounts are suitable and, moreover, would require "documentation" of that determination. Meanwhile, the NASD also has incorporated the topic of "Analyzing Variable Annuity Subaccounts" into its e-learning course entitled, "Variable Annuity II: Understanding Professional Responsibility and Ethical Sales Practices."

Nothing less than such professional education and approval of proposed new Rule 2821 should be required to protect the interests of investors purchasing variable annuities.

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James J. Eccleston is a securities attorney, representing customers as well as brokers and brokerage firms nationwide in arbitration, litigation and regulatory matters. He maintains an informative website at [www.FinancialCounsel.com](http://www.FinancialCounsel.com). He is an equity partner with Shaheen, Novoselsky, Staat, Filipowski & Eccleston, and can be reached at 312-621-4400.



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20 North Wacker Drive, Suite 2900, Chicago, Illinois 60606  
Telephone: 312-621-4400 | Fax: 312-621-0268

