Variable Sleaziness

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False statements. Deliberate deception. Sloppy paperwork. A report this month by securities regulators about practices employed by the sellers of variable annuities paints a pretty grim picture.

A joint investigation by the U.S. Securities and Exchange Commission and the NASD recites a long list of what the two agencies euphemistically call "weak practices." The report is fueling efforts to impose new disclosure and operating standards that would—at least in theory—rein in some of the more outrageous practices.

A variable annuity is a hybrid investment product containing elements of insurance and a mutual fund. In addition to life insurance, the insurance aspect provides tax-deferred treatment of accumulated earnings, while the mutual fund component provides stock market exposure.

Brokers love variable annuities because they carry big commissions—"typically above 5%." the report says. Forbes magazine, among others, has long advised against buying them, saying the benefits are not worth the cost. It is often difficult **for** customers to figure out exactly what they're paying for.

Variable annuities are issued by such major insurance companies as American Insurance Group (nyse: AIG - news - people), Hartford Financial Services (nyse: **I I 1 G** - news - people), Conseco (nyse: **CNO** - news - people), MetLife (nyse: MET - news - people) and the John Hancock Financial Services of Manulife Financial (nyse: MFC - news - people). They are also sold at such leading brokerages as Merrill Lynch (nyse: **MER** - news - people).

At least one firm, Waddell & Reed Financial (nyse: WDR - news - people), is contesting an NASD civil complaint alleging dubious practices in variable annuities sales. Various other regulators, including New York State Attorney General **Eliot Spitzer,** are poking around.

The SEC/NASD report certainly has the potential to adversely affect sales of these products. Among the "weak practices" cited in the 29-page report:
Brokers recommended annuities to customers for whom they were unsuited due to such factors as age, investment objectives, risk tolerance and need for liquidity.
Brokers gave "unfounded, false or misleading justifications" to clients to convince them to switch policies, which generate fresh commissions.

Broker supervisors weren't required to review transactions and investigate such red flags as excessive switching.
Firms employing brokers "did not identify and prevent manipulative and abusive sales practices."
Firms failed to disclose existence of additional fees, all the market risks, the lack of liquidity, long-term tax disadvantages, conflicts of interest and the fact that the "guaranteed death payment" is paid only when the client dies.
"Documentation supporting recommendations of variable products to customers was not maintained."
Brokerage training programs for its employees "did not address the sale or supervision of variable products."
To make their point even sharper, regulators released a nine-page-long list of enforcement actions brought against brokers involving sales of variable annuities.

The SEC/NASD report also recites a long list of "sound practices." Boiled down, they amount to this: Don't cheat the customers, tell them everything and accurately document what you do and say.

Proposed rules just issued by the NASD would require variable annuities sellers to make far more disclosures to clients—including their commissions.