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***38 IS A VARIABLE ANNUITY A "SECURITY"?: MAKING SENSE OF INCONSISTENT STATE
AND FEDERAL SECURITIES STATUTES**

[Jason A. Richardson \[FN1\]](#)

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Variable annuities are sold more aggressively than fake Gucci handbags on the streets of New York City. --
SmartMoney.com [\[FN1\]](#)

I. Introduction

Sales of variable annuities have grown at an enormous rate during the last decade. Despite the tremendous increase in sales, a growing consensus among experts in the financial industry finds that variable annuities are suitable for only a small percentage of the investing public. It should come as no surprise, then, that as variable annuity sales have increased, so too have reports of investor abuse involving such products. Regulators have identified abuse in the sale of variable annuities as a growing problem in the industry, and continually send warnings to the investing public to beware of fraud and other misconduct by brokers looking to enrich themselves at the expense of the unwary investor.

Variable annuities are a unique investment vehicle from a regulatory perspective. Because these products have both an insurance component and securities component, the states have been left to themselves to decide the best manner in which to regulate their purchase and sale. Some states consider variable annuities to fall within the definition of "security" as provided in the state's respective securities statutes. The majority of states, however, do not consider a variable annuity to be a "security." The resulting patchwork of state security statutes may leave the multi-jurisdictional practitioner in a quandary as to the appropriateness of invoking a particular state's securities act in cases involving annuity sales. The applicability of securities statutes is important because most provide injured investors with remedies such as attorneys' fees, interest, costs and other equitable relief. These remedies might not otherwise be available to claimants bringing claims under common law causes of action.

The purposes of this article are to: (1) briefly introduce the reader to the variable annuity as an investment product; (2) identify common abuses often perpetrated by those selling variable annuities; (3) provide guidance for determining whether or not a particular state's securities laws apply to variable annuities; and (4) suggest alternative causes of action for cases arising in jurisdictions in which variable annuities are not considered to be "securities."

***39 II. What is a Variable Annuity?**

A variable annuity, also commonly referred to as a variable life insurance contract, is a hybrid investment product containing both securities and insurance components. [\[FN2\]](#) The dual nature of this type of investment product has created a patchwork of confusing regulatory efforts. As noted in one variable annuity prospectus:

Our products are subject to a complex and extensive array of state and federal tax, securities and insurance laws, and regulations, which are administered and enforced by a number of governmental and self-regulatory authorities. [\[FN3\]](#)

A. The Securities Component.

The securities component of a variable annuity provides the purchaser with the potential to obtain capital appreciation and earn income through investments in various securities products (such as mutual funds, stocks or bonds). As a result, the purchaser bears the risk of the market as long as he or she owns the annuity. When a variable annuity is purchased, the amount paid is invested in securities held within the annuity's "sub-account." In most cases, the purchaser is offered a list of available securities to populate the sub-account, and may choose to diversify the portfolio in the same manner as any other brokerage account. The value of the annuity will fluctuate as the value of the assets held in the sub-account rises or falls over time. Sub-accounts overconcentrated in any particular security or asset class may be disproportionately affected by volatility in the market. The time period during which the annuity sub-account holds securities is commonly referred to as the "accumulation phase."

B. The Insurance Component.

The insurance component of a variable annuity provides the purchaser with the means to mitigate market risk. For example, the purchaser may elect to "annuitize" the investment, meaning that at the end of the accumulation phase the insurance company will provide the purchaser with a series of periodic payments over time (the payment amount is determined, in part, by the value of the investment at the time it is annuitized). In addition, the insurance company may offer a "death benefit" to the purchaser's beneficiary, meaning that if the purchaser dies during the accumulation phase and the account balance is less than a certain, predetermined benchmark (often times the beginning balance amount), the insurance company will pay an amount equal to the deficiency to the beneficiary. The variable annuity's insurance features aren't free. The purchaser is subjected to management fees in much the same manner as owners of mutual funds in traditional brokerage accounts. The insurance company levies fees for "mortality and expense" charges, which are comparable to 12b-1 fees assessed by load mutual fund companies. Other fees include charges for riders or other special features (such as enhanced death benefits or guaranteed minimum income benefits), front end or back end loads, administrative fees, advisory fees, and other underlying fund expenses. [\[FN4\]](#) One study by Morningstar found that the average annual expense on variable annuity sub-accounts stands at 2.3% of assets. [\[FN5\]](#) By *40 comparison, the average mutual fund charges just 1.44%. [\[FN6\]](#)

Variable annuities are intended to be long term investments. The insurance company will charge a significant "surrender penalty" to the purchaser if he or she attempts to liquidate the sub-account during the first few years of the accumulation phase (usually between five to ten years, depending on the individual contract). The amount of the surrender penalty should be clearly set forth in the annuity's prospectus, and usually decreases with time. According to Morningstar, the average surrender penalty is 7.2%. Not coincidentally, the surrender penalty usually bears a striking similarity to the commission paid by the insurance company to the salesman.

C. Tax Considerations.

Variable annuities are entitled to favorable tax treatment under the Internal Revenue Code. [\[FN7\]](#) The tax-deferral features of the variable annuity allow for growth during the accumulation phase without triggering income or capital gains taxes. Further, the tax-deferral feature permits owners to make changes in the sub-account portfolio without incurring any tax liability. Note, however, that withdrawals made before age 59 1/2 may be subjected to a 10% early withdrawal tax penalty.

Gains in the sub-accounts are taxed at ordinary income tax rates, which may be as high as 35%, as opposed to capital gains tax rates, which may be 15% or lower. [\[FN8\]](#) In the event of the purchaser's death during the accumulation phase, the beneficiary may receive the proceeds of the death benefit tax free, but any gains in the sub-account are taxed as ordinary income. This is in sharp contrast to the tax treatment of ordinary securities, which are generally inherited at the stepped-up basis at the time of owner's death.

III. Unsuitable Sales Practices Relating to Variable Annuities.

In 2005, the North American Securities Administrators Association ("NASAA") published its annual top ten list of "Threats to Investors." [\[FN9\]](#) Variable annuity sales practice ranked number 9 on the list. That same year, California's Department of Corporations (the state's securities regulator) published its annual "'Dirty Dozen' Investment Scams" notice to investors. [\[FN10\]](#) Variable annuities sales ranked number 2 on the list. The SEC/NASD Joint Report of 2004 identified a host of abusive sales practices perpetrated by brokers and brokerage firms, although the report euphemistically referred to them as "weak practices." [\[FN11\]](#) The commissions available to those who sell variable annuities are steep, "typically above 5%," [\[FN12\]](#) and provide a powerful incentive to aggressively market such products to customers for whom they are unsuited. According to the JOINT REPORT, brokers routinely recommend variable annuities without regard to customers' age, investment objectives, risk tolerance, need for liquidity, eligibility for the *41 investment and other critical factors. [\[FN13\]](#) Further, brokerage firms have inadequately supervised their registered representatives, and failed to control inappropriate sales practices. [\[FN14\]](#) These types of warnings to the public paint a grim picture of the brokerage industry's practice of selling variable annuities to unwary investors.

A. Variable Annuities are Subject to Industry Rules Regarding Suitability.

As noted by the former NASD (n/k/a FINRA) Chairman and CEO Robert R. Glauber, "Variable insurance products have always been subject to the suitability, disclosure and other requirements that apply to all securities." [\[FN15\]](#) In other words, the sale of variable annuities is subject to the suitability rules of the NASD as set forth in NASD Conduct Rule 2310. [\[FN16\]](#) In 1986, the NASD issued a Notice to Members that outlines factors in determining whether a variable annuity is suitable for a given client. [\[FN17\]](#) Those factors include, but are not limited to, "the customer's need for liquidity", "the customer's need for retirement income," and "the customer's willingness to invest a set amount on a yearly basis." [\[FN18\]](#)

For retired investors needing immediate income, variable annuities are rarely suitable. Liquidity problems, ongoing fees and expenses, volatility in the values of mutual funds in the sub-accounts, and the fact that withdrawals for income during the investor's lifetime could ultimately diminish the death benefit may make variable annuities unsuitable for retirees. Such investments do very little for the living who need retirement income, and even less for their heirs should withdrawals be necessary. Also, the tax-deferred feature of a variable annuity is wasted on an IRA, which is already tax-deferred.

The sale of variable annuities has been under intense scrutiny by the NASD. In a notice to members in 2000, [\[FN19\]](#) the NASD reminded members of their supervisory obligations with respect to the sale of variable annuities, and reported on recent disciplinary actions against brokers who sold variable annuities. One common factor in the NASD's disciplinary decisions was the fact that the variable annuity had been sold to a retiree. [\[FN20\]](#)

Considering the comparatively high fees, lack of liquidity, adverse tax consequences upon death, and crushing surrender penalties, it is safe to say that variable annuities are only suitable for a small group of investors. This would include investors who are relatively young (under age 40), maximize their annual IRA and/or 401(k) contributions, and have little-to-no need for liquidity.

***42 B. Common Unsuitable Sales Practices**

The concept of suitability extends not only to the recommendation to purchase the variable annuity itself, but also to the activity within the annuity sub-accounts as well. The sales practices listed below have been recognized as abusive and violative of the industry's *43 suitability rules.

i. Unsuitable Recommendation to Purchase a Variable Annuity.

Unsuitable variable product recommendations are made when the broker has no reasonable basis in light of information the broker may have had regarding the customer's age, financial or tax status, investment objectives, investment sophistication, low risk tolerance, need for liquidity, lack of or need for life insurance, ineligibility under the terms of the prospectus and other relevant information. Brokers who adopt a "one-size-fits-all" strategy in which every customer gets a variable annuity are likely ignoring their suitability duties.

ii. Commission Churning and Product Switching.

As explained above, brokers are entitled to a substantial commission for selling variable annuities. Churning occurs when a broker uses unfounded, false or misleading justifications as a basis for recommending that a customer switch variable annuities. Such switching may trigger significant surrender penalties, a fact often not disclosed to the customer, and provide enormous commissions to the broker. It is worth noting that many salespersons use the "bonus credit" offered by many insurance companies to justify an unsuitable switch, often characterizing the bonus as "free money." A bonus credit provides the annuity purchaser with a small addition to the contract's beginning account value (typically between 1% to 5% of the amount invested). While this may provide the investor with a higher initial principal, the bonus almost always comes with costly strings attached. Increased surrender penalties, longer surrender periods, and inflated expenses are just some of the ways the purchaser may be disadvantaged by electing to take the bonus credit. In many cases the costs of a bonus credit may actually far exceed the benefits.

iii. Failure to Disclose Material Information.

Brokers have a duty to disclose all fees, costs, and risks associated with the purchase of a variable annuity, as well as to explain the lack of liquidity of variable products, guaranteed death benefit, tax implications and the potential consequences of financing variable products. In cases of switching variable products, the broker must disclose whether or not the transaction will lead to a surrender penalty or loss of bonus credit.

iv. Unsuitable Asset Allocation of the Annuity Sub-Account.

Even if the variable product is suitable for the customer, the broker must adhere to principles of suitability when making investment recommendations for the annuity sub-accounts. For example, sub-accounts overconcentrated in high-risk securities may be unsuitable for a customer with a low risk tolerance and conservative investment objective.

IV. Is a Variable Annuity a "Security"?

Victims of variable annuity sales abuse have many choices when it comes to selecting appropriate causes of action. In many jurisdictions, the claimant may be able to invoke the applicable securities act in order to take advantage of statutorily provided remedies, such as attorneys' fees, costs, interest, etc. However, only a minority of states recognize variable annuities as securities, notwithstanding the fact that the annuity sub-accounts consist entirely of stocks and bonds (by way of mutual funds). This section will attempt to provide guidance for determining whether or not a particular jurisdiction's securities statutes provide investors with protection in cases of unsuitable variable annuity sales.

***44 A. Variable Annuities Are Considered "Securities" Under Federal Law**

In *S.E.C. v. Variable Annuity Co.*, [\[FN21\]](#) the United States Supreme Court held that a variable annuity is a "security," as the term is defined in the Securities Act of 1933. [\[FN22\]](#) In *Variable Annuity Life*, the Court was tasked with determining whether or not insurance companies that issued variable annuities were required to register such products with the Securities and Exchange Commission. The insurance companies argued that the Securities Act's exemption for insurance products applied to variable annuities, and therefore such products were excluded from the definition of "security." The SEC had attempted to enjoin the insurance companies from offering their variable annuity contracts without properly registering them with the Commission. The Court sided with the SEC, and found that the Act's

definition of "security" was broad enough to include variable annuity contracts, and therefore, the Court held, such products must be registered in accordance with the Securities Act. The Court's holding has never been overturned.

In reaching its conclusion, the Court explained that the insurance component of the variable annuity was not substantial enough to justify nullifying legislative protections provided in the Securities Act. The Court stated:

[A]bsent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company. The holder gets only a pro rata share of what the portfolio of equity interests reflects—which may be a lot, a little, or nothing But we conclude that the concept of "insurance" involves some investment risk-taking on the part of the company. The risk of mortality, assumed here, gives these variable annuities an aspect of insurance. Yet it is apparent, not real; superficial, not substantial. In hard reality the issuer of a variable annuity that has no element of a fixed return assumes no true risk in the insurance sense The companies that issue these annuities take the risk of failure. But they guarantee nothing to the annuitant except an interest in a portfolio of common stocks or other equities [footnote omitted]—an interest that has a ceiling but no floor. [footnote omitted] There is no true underwriting of risks, [footnote omitted] the one earmark of insurance as it has commonly been conceived of in popular understanding and usage. [\[FN23\]](#)

As a result of the Court's decision, investors victimized by abusive or unsuitable sales practices relating to variable annuities may choose to plead causes of action arising under federal securities laws. Whether or not this is advisable is outside the scope of this article, as there are strong arguments both for and against invoking the anti-fraud provisions of the various federal securities statutes.

B. Variable Annuities May Be Considered "Securities" Under State Law

The Securities Act of 1933 preserves the right of the individual states to regulate securities fraud. [\[FN24\]](#) As a result, each state is free to establish the scope of protection afforded to investors, and define the term "security" in a manner which may or may not include variable annuities. It should come as no surprise that there are significant differences in the states' treatment of variable products. Only a minority of states consider variable annuities to fall within the definition of "security" as provided in the state's respective *45 securities statutes. The majority of states, however, have declined to do so.

In 2006, the Hawaii Legislature published an exhaustive study of state securities statutes relating to variable annuity contracts. [\[FN25\]](#) The HAWAII REPORT included an ambitious survey of the fifty states' securities statutes' definitions of "security," and whether or not the definitions excluded variable annuities. The results of the HAWAII REPORT, as well as the methodology employed in the study, are explained below.

i. Statutory Construction and Interpretation

The first step in determining whether or not a particular state's securities act applies to variable annuities is to analyze the text of the provision defining the term "security." The vast majority of such statutes exclude certain annuities from the definition of "security." At first blush it is difficult to determine whether fixed and variable annuities are treated equally under such statutes. For states that have adopted some version of the Uniform Securities Act ("USA"), [\[FN26\]](#) the official code comments provide guidance for statutory interpretation.

a. 1956 Version of the Uniform Securities Act

The 1956 version of the USA provides in Section 401(1) that:

"Security" does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay **[a fixed sum of]** money either in a lump sum or periodically for life or for some other specified period. (emphasis added)

The official comments applicable to Section 401(1) provides that:

The last sentence has been explicitly phrased so as not to exclude from the definition the so-called "variable annuities" which have been recently developed. ... If it is desired to exclude variable annuities along with orthodox annuities on the ground that the former are sufficiently regulated by the insurance authorities in the particular state, **the bracketed language** should be deleted. [\[FN27\]](#)

Simply stated, if the text of the definitions statute retains the phrase "a fixed sum of," then the definition of "security" includes variable annuities. If the phrase has been removed, then the term "security" does not include variable annuities.

Using Washington as an example, the state's statutory definition of "security" specifically excludes an "annuity contract under which an insurance company promises to pay **a fixed sum** of money either in a lump sum or periodically for life or some other specified period." [\[FN28\]](#) Note the phrase "a fixed sum" has not been deleted. Accordingly, the term "security" includes variable annuities under Washington's Securities Act.

The HAWAII REPORT indicates that the following states have adopted the 1956 *46 version of the USA: Alabama, Alaska, Arkansas, Connecticut, Delaware, Indiana, Kentucky, Maryland, Massachusetts, Michigan, Mississippi, Montana, New Hampshire, New Jersey, North Carolina, Oregon, Pennsylvania, Utah, Virginia, Washington, West Virginia, Wisconsin and Wyoming.

b. 1985 Version of the Uniform Securities Act

The 1985 version of the USA appears to have been drafted with the assumption that variable annuities are securities. Section 101(16) of the 1985 version of the USA provides:

The term [security] does not include ... an insurance or endowment policy or annuity contract under which an insurance company promises to pay **a fixed sum of money either in a lump sum or periodically for life or some other** specified period. (emphasis added)

The official comment for this section provides that:

Similarly, insurance products providing for the payment of **a fixed sum** of money are excluded from the definition. **Variable annuities and similar** products are treated as securities under this definition, **but are exempted** from registration under Section 401(4). [\[FN29\]](#)

Accordingly, under the 1985 version of the USA, variable annuities are considered to be "securities" by default. The exclusion of annuities from the definition of "security" is therefore limited only to fixed annuities. Like the 1956 version of the USA, if the term "a fixed sum" is deleted from the statute, the definition of "security" will not include variable annuities. The HAWAII REPORT indicates that the following states have adopted the 1985 version of the USA: Colorado, Montana, Nevada, New Mexico, and Rhode Island.

c. 2002 Version of the Uniform Securities Act

The 2002 version of the USA provides a third framework for analysis. Under Section 102(28), the term "security"

does not include an insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed **[or variable]** sum or money either in a lump sum or periodically for life or other specified period; (emphasis added)

The official code comment to Section 102(28) provides:

The Drafting Committee recognized that the decision whether to exclude variable annuities from the definition of security will be made on a state-by-state basis. **Those states which intend to exclude variable products from the definition of security should add the words "or variable" ...** [\[FN30\]](#)

Therefore, if the definitions statute retains the phrase "or variable" then the term "security" does not include variable annuity contracts. If the phrase "or variable" has been deleted, then the term "security" includes variable annuity contracts.

In the case of Minnesota, for example, the term "security" excludes an "an annuity contract under which an insurance company *47 promises to pay a fixed **or variable** sum of money either in a lump sum or periodically for life or other specified period." [\[FN31\]](#) Note that the term "or variable" has not been deleted from the text. Accordingly, variable annuities are not included in the definition of "security." The HAWAII REPORT indicates that the following states have adopted the 2002 version of the USA: Hawaii, Idaho, Iowa, Kansas, Maine, Minnesota, Missouri, Oklahoma, South Carolina, South Dakota, and Vermont.

d. Non-Uniform Securities Act States

Many states have not chosen to adopt any of the three versions of the Uniform Securities Act described above, including: Arizona, California, Florida, Georgia, Illinois, Louisiana, New York, North Dakota, Ohio, Tennessee, and Texas. In these jurisdictions, the text of the definitions statutes must be interpreted without the benefit of the USA's official comments. Fortunately, many of these states have specifically addressed the issue of variable annuities in the statutory text. For example, in California, the definition of "security" excludes an "annuity contract under which an insurance company admitted to this state promises to pay a sum of money (**whether or not based** upon the investment performance of a segregated fund) **either in a lump sum or** periodically for life or some other specified period." [\[FN32\]](#) Georgia [\[FN33\]](#) and Louisiana [\[FN34\]](#) similarly provides an exclusion for "any variable annuity contract." States such as Tennessee [\[FN35\]](#) and Texas [\[FN36\]](#) simply exclude all annuity contracts, without distinguishing between fixed and variable annuities.

ii. Jurisdictions in Which Variable Annuities Are "Securities"

In addition to the methodology of statutory construction and interpretation explained above, the researchers for the HAWAII REPORT used additional means to form the Report's conclusions. Researchers contacted the securities administrators of many states to inquire about their respective interpretations of their securities acts. Further, they compiled evidence of enforcement actions relating to variable annuity contracts, brought under the various states' securities acts. This permitted them to infer that in states such as Massachusetts and Missouri, variable annuities are considered to be "securities." [\[FN37\]](#) Ultimately, the HAWAII REPORT concludes that the securities acts of the following states apply to variable annuities: Arizona, Florida, Hawaii, Kentucky, Massachusetts, Missouri, Montana, Nevada, New York, North Dakota, Rhode Island, South Dakota, Vermont, and Washington. [\[FN38\]](#)

iii. Jurisdictions in Which Variable Annuities Are Not "Securities"

The HAWAII REPORT concludes that the securities statutes of the following states do not apply to variable annuities: Alabama, Alaska, Arkansas, California, Colorado, *48 Connecticut, Delaware, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi, Nebraska, New Hampshire, New Jersey, New Mexico, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Tennessee, Texas, Utah, Virginia, West Virginia, Wisconsin and Wyoming. [\[FN39\]](#)

V. Alternative Causes of Action in Jurisdictions Where the Securities Act Does Not Include Variable Annuities.

In those jurisdictions in which an injured investor is precluded from invoking the state's securities act, several common law causes of action may be available to provide the claimant with the desired relief. This section will provide examples of potentially viable causes of action from several jurisdictions that may be pled in variable annuity cases.

A. Breach of Contract

An investor subjected to abusive and unsuitable sales practices may have a viable cause of action for breach of contract. When a brokerage firm has agreed to abide by regulatory laws and rules, such rules are deemed incorporated into the customer/broker agreement and a violation of those laws and rules constitutes a breach of contract, as noted in *Brumm v. McDonald & Co.* [\[FN40\]](#) As the *Brumm* court explains,

"[a]dditionally we note a number of cases in which customers of stockbrokers are deemed to have contemplated and authorized a course of dealing in accordance with the rules and customs of the stock exchanges. See, e.g., *Merrill Lynch, Pierce, Fenner & Smith Inc.* (1966), 90 N.J.Super. 565, 570, 218 A.2d 655, 657-658; *Lynch v. Maw* (1955), 3 Utah 2d 271, 274, 282 P.2d 841, 843; *Korns v. Thomson & McKinnon* (D.Minn. 1938), 22 F.Supp. 442, 447. **Thus the exchange rules are deemed incorporated into any agreement** between customer and broker. *Thomson McKinnon Securities, Inc. V. Clark* (C.A.11 1990), 901 F.2d 1568, 1570-1571." [\[FN41\]](#)

The *Brumm* court is not alone in its holding, and it is well established that where a brokerage firm agrees to comply with regulatory requirements, a violation of suitability rules is a breach of contract. [\[FN42\]](#) In *Komanoff v. Mabon, Nugent & Co.*, the Court explained that regardless of whether an investor could assert a private cause of action based directly on the violation of an SRO rule, the investor had a viable breach of contract cause of action based on the same violation. [\[FN43\]](#) Accordingly, in addition to *49 breaching the express agreements and assurances made to the customer by the broker or firm that they would carefully and prudently invest the customer's assets, the broker and firm, by violating SRO rules, may have breached the contract(s) they made with the customer.

B. Negligence

Violation of securities industry rules may give rise to a claim of negligence. The underlying theory of a negligence claim is that the broker and/or firm owed the customer a duty of care, they breached that duty through their failure to abide by industry rules, and as a result, caused the customer to incur losses. In Texas, at least two federal courts have held that NASD rules may be used as evidence of the appropriate standard of care owed to brokerage customers. [\[FN44\]](#) Evidence tending to establish a variance between conduct called for by a firm's procedures and the actions actually undertaken by an employee of the firm may support a finding of liability. [\[FN45\]](#) Also, a violation of internal procedures may support a punitive damages award. [\[FN46\]](#) Finally, "a court [or other arbiter] may consider evidence of [a] brokerage firm's internal rules as evidence of the proper standard of care." [\[FN47\]](#)

C. Negligent Misrepresentation

A claim for negligent misrepresentation may be appropriate in cases in which fraud may be difficult to prove because of the requirement to demonstrate scienter on the part of the wrongdoer. The California Supreme Court in *Small v. Fritz* explains that the elements of a negligent misrepresentation claim require demonstrating "[t]he assertion, as a fact, of that which is not true, by one who has no reasonable ground for believing it to be true" ([Cal.] Civ. Code, § 1710, subd. (2)), and "[t]he positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true" ([Cal.] Civ. Code, § 1572, subd. (2))." [\[FN48\]](#) In Illinois, to state a claim for negligent misrepresentation, a claimant must allege:

(1) a false statement of material fact; (2) carelessness or negligence in ascertaining the truth of the statement by the party making it; (3) an intention to induce the other party to act; (4) action by the other party in reliance on the truth of the statement; (5) damage to the other party resulting from such reliance; and (6) a duty on the party making the statement to communicate accurate information. [\[FN49\]](#)

D. Fraudulent Misrepresentation

Claims involving churning and unsuitable annuity switching may lend themselves to a claim of fraud. The large

commissions "earned" by the broker in such transactions, *50 coupled with the lack of any reasonable basis for such a costly transaction may allow the arbitration panel to find scienter on the part of the salesman. [\[FN50\]](#) In Florida, the elements of fraudulent misrepresentation are "(1) a false statement concerning a material fact; (2) the representor's knowledge that the representation is false; (3) an intention that the representation induce another to act on it; and, (4) consequent injury by the party acting in reliance on the representation." [\[FN51\]](#)

E. Elder Abuse

Several states provide statutory protection for the elderly that cover financial abuse. In California, for example, one such statute defines "elder financial abuse" as when a person or entity does any of the following: 1) takes, secretes, appropriates, or retains real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both; or 2) assists in taking, secreting, appropriating, or retaining real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both. [\[FN52\]](#) Remedies under this statute include attorneys' and costs. [\[FN53\]](#)

VI. Conclusion

Sales abuse relating to the sale of variable annuities is likely to continue until both the brokerage firms that sell them and the authorities that regulate them succeed in adequately addressing the "weak practices" that exist in the industry. While the local state's securities statutes may not always be available for the injured investor in variable annuity cases, he or she may be able to seek protection or redress by pleading several other powerful common law or statutory claims.

[\[FN a1\]](#). Jason Richardson is an attorney with the law firm of Shepherd, Smith & Edwards, L.L.P. located in Houston, Texas. He received his J.D. and M.B.A. degrees from the University of Houston in 2006, and is a member of the Texas and Illinois Bars. Mr. Richardson and the other members of his firm have a nationwide practice devoted to helping investors recover wrongful losses from brokerage firms and have represented thousands of customers from many states in their desire to aid the public investor. He can be reached at jrichardson@sselaw.com.

[\[FN1\]](#). What's Wrong with Variable Annuities, SmartMoney.com, at <http://www.smartmoney.com/retirement/investing/index.cfm?story=wrongannuities> (updated September 10, 2007).

[\[FN2\]](#). Joint SEC/NASD Staff Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products, Securities Exchange Commission and National Association of Securities Dealers, at 2 (June 9, 2004), at <http://www.sec.gov/news/studies/secnasdvp.pdf> (referred to hereinafter as the "JOINT REPORT").

[\[FN3\]](#). Prospectus, ING GoldenSelect Premium Plus® Deferred Combination Variable and Fixed Annuity Contract, at 7 (April 30, 2007).

[\[FN4\]](#). JOINT REPORT, *supra* note 2, at 6-7.

[\[FN5\]](#). *Id.* at 6.

[\[FN6\]](#). *Id.*

[\[FN7\]](#). *Id.* at 7.

[\[FN8\]](#). *Id.*

[\[FN9\]](#). NASAA's 2005 Top 10 Threats to Investors, North American Securities Administrators Association (March

24, 2005), at http://www.nasaa.org/nasaa_newsroom/current_nasaa_headlines/2719.cfm#.

[FN10]. California Issues "Dirty Dozen" Investment Scams for 2005, William P. Wood, Commissioner, California Department of Corporations, News Release 05-03 (February 2, 2005), at <http://www.corp.ca.gov/pressrel/05/corp/nr0503.htm>.

[FN11]. JOINT REPORT, *supra* note 2, at 9.

[FN12]. *Id.* at 2.

[FN13]. *Id.* at 9.

[FN14]. *Id.* at 10.

[FN15]. Press Release, U.S. Securities and Exchange Commission, SEC and NASD Release Joint Staff Report on Broker-Dealer Sales of Variable Insurance Products, 2004-80 (June 9, 2004), available at <http://www.sec.gov/news/press/2004-80.htm>.

[FN16]. Section 2310 of the NASD's Conduct Rules provides: In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer on the basis of facts, if any, disclosed by such customer as to his other security holdings and to his financial situation and needs.

[FN17]. NASD NTM 96-86.

[FN18]. *Id.*

[FN19]. NASD NTM 00-44.

[FN20]. A sampling of additional relevant NASD guidance and criticism is as follows:

- NASD NTM 97-27 (Reminding its members of their compliance obligations with respect to the sale of group variable contracts).
- NASD NTM 99-35 (Establishing best practice guidelines for the supervision of the sale of variable annuities).
- NASD NTM 04-45 (Setting forth a proposed rule governing the purchase, sale, or exchange of variable annuities and stating that the "NASD has become increasingly concerned about some members' unsuitable recommendations and inadequate supervision of transactions in deferred variable annuities").
- NASD Press Release dated February 15, 2001: "NASD Regulations files Six Enforcement Actions Involving Marketing and Sales of Variable Annuities."
- NASD Press Release dated December 5, 2001: "NASD Regulation Announces Two Enforcement Actions Involving Sales of Variable Annuity and Life Insurance Contracts."
- NASD Press Release dated December 4, 2002: "NASD Fines American Express Financial Advisors \$350,000 for Improper Sales of Variable Annuities and Life Insurance."
- NASD Press Release dated May 27, 2003: "NASD Takes Disciplinary Actions for Variable Annuity Abuses and Issues Investor Alert on Variable Products" ("[i]nvesting in a variable annuity within a tax-deferred account, such as an individual retirement account may not be a good idea. Since IRAs are already tax-advantaged, a variable annuity will provide no additional tax savings. It will, however, increase the expense of the IRA, while generating fees and commissions for the broker or salesperson.")
- NASD Press Release dated July 30, 2003: "NASD Charges Louisiana Broker with Unsuitable Sales of Variable Annuities and Mutual Funds of More than \$6 Million."

- NASD Press Release dated January 12, 2004: "NASD Bars Louisiana Broker and Orders Restitution for Unsuitable Sales of Variable Annuities and Mutual Funds."
- NASD Press Release dated January 14, 2004: "NASD Charges Waddell & Reed with Suitability Violations Relating to Thousands of Variable Annuity Exchanges and Seeks Customer Compensation; Two Senior Execs Also Charged."
- NASD Press Release dated January 29, 2004: "NASD Fines Prudential \$2 Million; Orders \$9.5 Million to Customers for Annuity Sales in Violation of NY Insurance Regs."
- NASD Press Release dated April 26, 2004: "NASD Proposes Specific Requirements for Deferred Variable Annuity Sales; Concerns Over Suitability, Disclosure, Supervision Cited."
- NASD Press Release dated May 20, 2004: "NASD Disciplines Three Firms, Three Brokers for Variable Annuity Abuses; Total Fines Exceed \$500,000, With Two Brokers Permanently Barred."
- NASD Press Release dated June 9, 2004: "SEC and NASD Release Joint Staff Report On Broker-Dealer Sales of Variable Insurance Products."
- NASD Press Release dated November 29, 2004: "NASD Bars Former AmSouth Broker for Fraud in the Sale of Variable Annuities."
- NASD Press Release dated April 29, 2005: "Waddell & Reed, Inc. Agrees to Pay \$5 Million Fine, up to \$11 Million in Restitution to Settle NASD Charges Relating to Variable Annuity Switching."

[FN21]. [S.E.C. v. Variable Annuity Life Insurance Co. of America, 359 U.S. 65 \(1959\).](#)

[FN22]. [15 U.S.C. § 77b \(a\)\(1\).](#)

[FN23]. [Variable Annuity Life Ins. Co. of America, 359 U.S. at 69-73.](#)

[FN24]. [15 U.S.C. § 77r \(c\)\(1\).](#)

[FN25]. Dean Sugano, Variable Annuity Contracts Under State Statutes Relating to Securities and to Insurance, Legislative Reference Bureau, December 2006, at <http://hawaii.gov/lrb/rpts06/annuity.pdf> (hereinafter referred to as the "HAWAII REPORT").

[FN26]. The Uniform Securities Act first appeared in 1956, and was updated in 1985 and 2002.

[FN27]. HAWAII REPORT, supra note 25, at 29 (citing Uniform Securities Act (1956), as Amended, page 37, official code comment on section 401(1). National Conference of Commissioners on Uniform State Laws, at <http://www.nasaa.org>) (emphasis added).

[FN28]. [Wash. Rev. Code § 21.20.005\(12\)\(b\) \(2002\).](#)

[FN29]. HAWAII REPORT, supra note 25, at 30 (citing Uniform Securities Act (1985), with 1988 Amendments, page 15, official code comment on section 101(16), National Conference of Commissioners on Uniform State Laws, at <http://www.uniformsecuritiesact.org>).

[FN30]. HAWAII REPORT, supra note 25, at 30-31 (citing Uniform Securities Act (Last Revised or Amended in 2005), pages 32-34, official code comment on section 102(28), National Conference of Commissioners on Uniform State Laws, at <http://www.uniformsecuritiesact.org>) (emphasis added).

[FN31]. MINN. STAT. § 75-71-105(n).

[FN32]. [Cal. Corp. Code § 25019 \(2001\).](#)

[FN33]. [Ga. Code Ann. § 10-5-2\(a\)\(26\)](#) (2002).

[FN34]. [La. Rev. Stat. Ann. § 51:702\(15\)\(b\)](#) (2006).

[FN35]. [Tenn. Code Ann. § 48-2-102\(16\)](#) (2002).

[FN36]. TEX. REV. ANN. 581-4(A).

[FN37]. See HAWAII REPORT, *supra* note 25, at 28 (providing several enforcement actions and consent orders initiated by Massachusetts' and Missouri's securities administrators).

[FN38]. See HAWAII REPORT, *supra* note 25, at Table 4.

[FN39]. See HAWAII REPORT, *supra* note 25, at Table 4.

[FN40]. See, e.g., [Brumm v. McDonald & Co., 603 N.E.2d 1141 \(Ohio 1942\)](#).

[FN41]. *Id.* (Emphasis added).

[FN42]. [Komanoff v. Mabon, Nugent & Co., 884 F. Supp. 848, 859-60 \(S.D.N.Y. 1995\)](#).

[FN43]. *Id.* Accord, [Hofmayer v. Dean Witter & Co., 459 F. Supp. 733, 739 \(N.D. Cal. 1978\)](#) (where plaintiff alleged violations by defendant of certain rules of the Chicago Board of Trade and the Chicago Mercantile Exchange, plaintiff's claim "should properly have been separated into two counts, for it allege[d] both a breach of contract requiring [defendant] to abide by the rules of any exchange or market where transactions are executed, and an independent claim arising from the violation of the rules."); [Iowa Grain v. Farmers Grain and Feed Co., 293 N.W.2d 22, 25 \(Iowa 1980\)](#) ("A broker's covenant with its customer that it will follow exchange rules and customs establishes a contractual duty to the customer."); [Index Futures Group, Inc. v. Ross, 199 App.3d 468, 145 Ill. Dec 574, 557 N.E.2d 344, 347 \(Ill App. 1990\)](#), cert. denied, [133 Ill.2d 557, 561 N.E.2d 692 \(1990\)](#). See also, [Geyer v. Paine, Webber, Jackson & Curtis, Inc., 389 F.Supp. 678 \(D. Wyo. 1975\)](#); [Avern Trust v. Clarke, 415 F.2d 1238 \(7th Cir. 1969\)](#); [Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc. 410 F.2d 135, 141 \(7th Cir. 1969\)](#) (Claimant is entitled to assert causes of action, including but not limited to breach of contract, for violations of NASD and NYSE Rules).

[FN44]. Nelson S. Ebaugh and Grace D. O'Malley, A Guide to Selecting Causes of Action Under Texas Law to Recover for Suitability Violations, 12 PIABA BAR J. 43, 49 (Spring 2005) (citing [Lange v. H. Hentz & Co., 418 F.Supp 1376 \(N.D. Tex. 1976\)](#) and [Mercury Inv. Co. v. A.G. Edwards & Sons, 295 F.Supp 1160 \(S.D. Tex. 1969\)](#)).

[FN45]. [Rupert v. Clayton Brokerage Co. of St. Louis, Inc., 737 P.2d 1106 \(Colo. 1987\)](#).

[FN46]. [Aldrich v. Thomson McKinnon Securities, Inc., 589 F.Supp. 683, 685 \(S.D.N.Y. 1984\)](#).

[FN47]. [Thropp v. Bache Halsey Stuart Shields, Inc., 650 F.2d 817, 820 \(6th Cir. 1981\)](#). See also [Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng, 697 F.Supp. 1224, 1227 \(D.D.C. 1986\)](#) (violation of NASD rule was evidence of broker's negligence).

[FN48]. [Small v. Fritz Companies, Inc., 65 P.3d 1255 \(Cal. 2003\)](#) (citing [Fox v. Pollack, 181 Cal.App.3d 954, 962 \(Cal. 1986\)](#) [describing elements of the tort]).

[FN49]. [Bd. of Educ. of Chicago v. A, C & S, Inc., 131 Ill. 2d 428, 452 \(1989\)](#). See also [Fox Assoc., Inc. v. Robert Half Int'l, Inc., 334 Ill. App. 3d 90, 94 \(Ill. App. Ct. 2002\)](#); [Neptuno Treuhand-Und Verwaltungsgesellschaft Mbh v. Arbor, 295 Ill. App. 3d 567, 572-74 \(Ill. App. Ct. 1998\)](#).

[FN50]. See [Franks v. Cavanaugh, 711 F. Supp. 1186 \(S.D.N.Y. 1989\)](#) (scienter element of churning may be inferred by evidence of excessive trading).

[FN51]. [Johnson v. Davis, 480 So.2d 625, 627 \(Fla. 1985\)](#).

[FN52]. [Cal. Welf. & Inst. Code § 15610.30](#) (2001).

[FN53]. [Cal. Welf. & Inst. Code § 15657\(a\)](#) (2001).

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