The Facts About Source of Funds

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Oct. 26, 2010 -- The insurance licensed producer makes a balanced presentation on the pros and cons of an index annuity. The consumer weighs the information and decides the annuity will do a better job of meeting his or her needs and sells a mutual fund to get the cash and then buys the annuity. Does the annuity producer need to be securities registered? No! No securities registration is needed by the annuity producer for this sale in any state of the union, including Arkansas.

On Sept. 18, 2009, the Arkansas Insurance Department and the Arkansas Securities Department issued Joint Bulletin No-14-2009 Sales Or Investment Advice Related To Securities Products By Insurance Producers. This bulletin has quickly become perhaps the most noted and misquoted piece of annuity regulation of recent times. Agents tell me it says that you can't use the proceeds from a securities sales to buy an annuity unless you are securities registered. The bulletin does not say that. It does not come close to saying that. What it says is this:

"The recommendation to replace securities such as mutual funds, stocks, bonds and various other investment vehicles defined as securities under the Arkansas Securities Act is the offering of investment advice. It is unlawful to offer investment advice unless one is registered (licensed) with the Arkansas Securities Department as an investment adviser or investment adviser representative."

One article I read mentioned the same language and then summarized is by saying that some states view it as a violation of law whenever an "insurance-only-producer" replaces ANY security product with an insurance or annuity sale. This view is 100 percent wrong because...

It is not just some states; the laws of EVERY STATE say you must be securities registered to recommend selling securities.

NO STATE says a securities license is required if the consumer decides to liquidate securities and use the proceeds to buy an annuity from a non-securities registered agent.

In my research, I found in every case the non-securities registered insurance agent was offering investment advice.

I have reviewed the securities laws of every state and every state regulatory action against an annuity producer that I could find relating to source of funds. In my non-legal opinion, where the issue of source of funds was raised there was clear evidence the non-securities registered annuity producer was giving securities advice in every situation and that is why the state took action.

Taking a look at why Arkansas may have issued the bulletin, we have a case (S-08-029) where the non-securities registered annuity producer not only recommended closing out securities accounts with B/Ds but filled out the forms for the consumer. In another case (S-08-074), the non-securities registered annuity producer put it in writing saying things like “If my calculations are correct (the securities account) is 80 percent at risk” and “We would suggest that you retain your GM stock and your bank stock.” In both cases the non-securities registered annuity producer suggested selling securities and using these proceeds to buy index annuities.

Most of the other cases I looked at also clearly showed the non-securities registered insurance agent telling a consumer to sell a security. In a few other cases the agent may not have recommended the sale of specific securities, but they presented themselves as experts in investments and investment advice. In several instances the agent is on record helping the prosecution by telling the investigator that they normally advised consumers on how the stock market worked and why stocks should be sold. This usually led to the investigator asking whether the agent had any training in investments or securities registration and the answer was always no.

Assuming the agent does not put the recommendation to sell in writing, it could come down to a consumer saying there was a recommendation to sell with the agent denying this. Although I have never seen this addressed anywhere, nor it should it be taken as legal advice, I wonder whether it would behoove the non-investment registered insurance agent to get a form signed by the consumer stating that in cases where securities proceeds were used to fund a fixed annuity that no recommendation was made by the agent to sell or replace securities such as mutual funds, stocks, bonds and various other investment vehicles defined as securities under state law in the purchase of the fixed annuity?

It can be expensive if a state decides you are a non-investment registered insurance agent that recommended selling securities to fund an annuity. In Arkansas the agent may be fined the greater of $10,000 or the commission earned for each violation ($20,000 or double the commission earned if the consumer is age 65 or older). However, if consumers look at their personal situation and make their own decision to sell securities and use the proceeds to buy an annuity, then no violation has occurred. Even Arkansas alludes to this in that previous case (S-08-029) where the state says the reason for the Consent Order is because the agent didn't merely recommend an annuity, but instead provided advice on securities matters.

I have found state regulators tend to look at several things to determine whether an insurance agent is acting as an advisor. One is a pattern of fixed annuity sales whereby the money came from the sales of securities. Another is the language used by the agent. Does the agent take about repositioning funds, allocating assets or advising the consumer? Still another red flag is if the agent helped the consumer complete the securities transfer or sales forms. It might be helpful for the agent to have a letter signed by the consumer saying the agent did not suggest selling securities as a source of funds for the fixed annuity. However, there are no absolute guaranteed ways to avoid an accusation by the state that an agent is offering investment advice in a fixed annuity sale.

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