

A

TARGETED MARKET CONDUCT EXAMINATION OF

LIFE INSURANCE COMPANY OF THE SOUTHWEST

NAIC #65528

As Of

December 31, 2009





Honorable Mary Taylor
Lt. Governor/Director
Ohio Department of Insurance
50 West Town Street Suite 300
Columbus, Ohio 43215

Lt. Governor:

Pursuant to your instructions and in accordance with the powers vested under Title 39 of the Ohio Revised Code, a targeted market conduct examination was conducted on the Ohio business of the following:

Life Insurance Company of the Southwest NAIC# 65528

The examination and risk assessment was conducted at the Ohio Department of Insurance:

50 West Town Street
Columbus, Ohio 43215

A report of the examination is enclosed.

Respectfully submitted,

Lynette Baker
Chief, Market Conduct Division

June 29, 2011

Date

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FOREWORD

This examination and risk assessment was conducted under authority provided under Ohio Revised Code (“R.C.”) 3901.011.

EXECUTIVE SUMMARY

This examination is a targeted market conduct examination of Life Insurance Company of the Southwest (“Company”) by the State of Ohio as it relates to the Company’s suitability compliance program for its fixed, individual annuity products for the period of January 1, 2003, through December 31, 2009, (the file review was conducted on annuities issued, replaced, or surrendered, during the period of March 1, 2007 through December 31, 2009). The examination began March 7, 2011, and concluded March 18, 2011.

A review of complaints indicated several areas of concern:

- Allegations of possible fraud, misrepresentation or forgery;
- Agents not giving all information on policy features;
- A general lack of understanding on the annuitant’s part of exactly what they were purchasing.

However, after completing the review of the complaints, the examiners found that these allegations all involved the actions of one agent. This is addressed in the “Compliant Handling” section of this report.

The most significant areas of concerns are:

- The major reason for the examiner’s inability to determine suitability was the lack of use of a suitability form on a consistent basis. The Company has a “Fact Finder” form available, but only rarely used it.
- Two of the new business files reviewed were identified as being possible unsuitable transactions; all of the other exceptions were for lack of financial information.
- There were four instances of unreported replacements.
- Company’s use of a product brochure as a disclosure.

SCOPE OF EXAMINATION

The basic business areas included as part of the examination included:

- A. Compliance
- B. New Business and Replacements
- C. Marketing and sales material
- D. Complaint Handling

Each business area has standards that were measured during the examination. Some of the standards have specific statutory guidance; others have specific company guidelines or contractual guidelines.

The focus of the examination was on the procedures and methods used by the Company to achieve compliance with applicable Ohio statutes and rules involving the issuance of fixed, individual annuity products. This included an analysis of how the Company communicates its instructions and philosophy with its employees, agency force, and national marketing organizations.

This examination report is a report by test, rather than a report by exception, and all standards and tests are described and the findings indicated.

METHODOLOGY

This examination is based on the standards and tests for a market conduct examination of a life and annuity insurer found in Chapters 16 and 19 of the NAIC Market Regulation Handbook and on applicable Ohio statutes and rules.

Some of the standards were measured using a single type of review, while others used a combination or all types of review. The types of review used in this examination fall into two general categories: Generic and Sample.

A “Generic” review indicates that a standard was tested through analysis of general data gathered by the examiners, or provided by the Company in response to interrogatories or personnel interviews conducted by the examiners.

A “Sample” review indicates that a standard was tested through direct review of a random sample of files selected using automated sampling software.

Each standard is accompanied by a comment describing the purpose or reason for the standard. Findings are indicated and any examiner comments or observations are noted.

COMPANY OPERATIONS

Life Insurance Company of the Southwest is a stock life insurance company, wholly owned by National Life Insurance Company and is domiciled in Vermont.

2009 Annuity Considerations

Ohio Individual Ordinary	National Individual Ordinary
\$24,320,009	\$1,306,994,648

FILE REVIEW METHODOLOGY:

The findings are based on the standards for a market conduct examination of a life and annuity insurer according to applicable Ohio statutes and rules, including Ohio Administrative Code (“OAC”) 3901-6-13 and 3901-6-14.

NEW BUSINESS AND REPLACEMENTS REVIEW FINDINGS

Standard 5: Marketing and Sales

The insurer has suitability standards for its products as required by OAC 3901-6-13 (G)(5), (7), and (8).

Standard 3: Marketing and Sales

The insurer’s rules pertaining to insurer requirements in connection with replacements are in compliance with OAC 3901-6-05.

Standard 11: Marketing and Sales

The insurer has procedures in place to educate and monitor insurance agents/producers and to provide full disclosure to consumers regarding all sales of products involving annuity products, and all sales are in compliance with OAC 3901-6-14 (E)(4)&(5) and R.C. 3901.21(A).

Procedure Review

Methodology: The examiners reviewed compliance procedure manuals and interviewed Company personnel to determine how new business and replacements are reviewed and processed.

Examiner Observations:

Methodology:

The examiners reviewed the Company’s compliance procedure manuals to determine how the issuance of annuities and the review of suitability are conducted. The procedures were reviewed in two phases: Prior to January 1, 2010, and January 1, 2010, and later.

Prior to January 1, 2010, the Company had established procedures for assuring the agent’s commitment to complying with established rules. The Company provided training, through its

website, of all internal and external employees on how annuities would be handled. The Company provided a list of guidelines to all agents that when adhered to would meet statutory requirements.

Some of these procedures included requirements that the producers have reasonable grounds for believing the annuity sale was suitable; that the agent should make reasonable efforts to obtain information to support the suitability of the sale, that records should be maintained of the information collected; and that the agents provide a list of items that should be considered prior to the sale. (e.g. does the contract exceed 50% of person's net worth?). The Company also listed procedures for auditing agent compliance with rules by performing occasional audits. The Company also required a "Suitability Acknowledgement for Annuity Sales" form to be completed by the agent and the annuitant. Also available for agent use was a "Fixed Annuity Fact-Finder" that could be utilized as a suitability form.

However, in practice, the Company did not document that these procedures were followed. Very few of the files had any suitability information. File documentation contained only a questionnaire that is part of the product brochure entitled "Is the Annuity Right For You". Documentation did not include important financial data supporting the suitability of the sale.

Also, the Company indicated that no internal audits of suitability were performed during the review period.

The Company did provide a LIMRA survey that allowed the annuitant to provide information, post-sale, on how the sale was conducted, and whether the annuitant understood the purchase.

The Company meets the statute requirements of OAC 3901-6-13 by maintaining written procedures but does not meet the standard for conducting periodic reviews of agent submissions.

The Company has an established replacement policy that is published on its website. The Company has created a Replacement Committee comprised of representatives from different business units that meets quarterly to discuss replacement activity. Any activity/transactions that appear questionable are reviewed and findings may lead to agent monitoring or disciplinary actions. The Company does have a conservation policy. Upon receipt of an outgoing replacement, a letter is sent to each policy owner advising of the possible impact of the replacement on their policy. A conservation email is generated to the servicing agent to assist in the conservation. Additionally, if the withdrawal charge exceeds \$15,000, the policy owner will be contacted by the Policy Service Staff to confirm that the person is aware of the applicable withdrawal charges.

Surrender activity is monitored weekly, by using an automatic, outgoing cash report that is reviewed by various levels of management and all regional vice presidents to assure no abuses are occurring.

Beginning in January 2010, the Company developed an enhanced system, 'Fixed Annuity Suitability Plan ("FASP")', for handling suitability, along with a new suitability form. Policies have also been developed that agents must follow to assure compliance with statutes. The

procedures are very detailed, with specific information on “red flags” to watch for, and include an annual audit plan for 2010 and 2011 (the procedures are for fixed and indexed annuities; the Company will still rely on broker/dealers review of suitability on variable products). The new form is comprehensive and provides the information needed to determine if a sale is suitable.

Marketing Materials:

<p>Standard 1: Marketing and Sales</p>

<p>Sales materials are not unfair and deceptive as defined by R.C. 3901.21.</p>

<p>Disclosures are compliant with OAC 3901-6-14.</p>

Overall the examiners found no issues with the marketing material provided by the Company, with the exception of the brochure/disclosures being used.

The Disclosure form used by the Company is not a separate form. The product brochure is used as the disclosure. Many of the product brochures have a ‘sign-off’ located at the bottom of each page indicating that the annuitant understands what is being discussed, etc. The brochure does include all the required information in OAC 3901-6-14.

Combining the disclosure with the lengthy product brochure causes fewer applicants to be given true disclosure, because applicants are much less likely to read and study a ten to fifteen page brochure than a simple two page disclosure. A two page Disclosure is suggested by most industry groups such as the American Council of Life Insurers.

A second issue with the brochure is the lack of consistency between the different products. Some of the brochures (Form No. 9295, 9027, 9446, 9447, and 9610) have a signature page that asks the annuitant to acknowledge they understand what they have read and received. Also, within the application there is a section, Section XII ‘Disclosure Information’, that asks for a signature indicating that the disclosure material was received and understood. Other brochures (Form No.9258, 9699, and 9920) have the disclosure signature page, but no section XII. In addition, the word “Disclosure” is not used on the cover page; instead the word “Summary” is used (however, the signature page and section XII are clearly labeled as “disclosure”).

Examiners recommendations:

- The Company should create a two page Disclosure document consistent with the Disclosure forms suggested by industry groups. The two page document will provide greater disclosure to applicants than the current ten page format since the longer format discourages review by the applicants. This would also eliminate the inconsistency between brochures.
- The Disclosure needs to include surrender charges, interest rates, participation rates, fees, and other specific information that will allow applicant to know what is going to occur with the annuity purchase.

File Review:

Methodology:

The examiners reviewed a sample of 50 Ohio new business and 50 replacement policies on fixed annuity contracts issued during the examination period. The major focus of the new business and replacements involved the issue of annuity suitability and the Company's oversight of its products. The Company misidentified several files as replacements, when actually they were non-replacement and non-replacements that were actually replacements (see 'Unreported Replacements' section for further explanation). A decision was made to not remove these files that were included in the incorrect samples because the results of the file review would not have affected the compliance rating.

New Business (non-replacement):

Population	Sample	Yes	No	Standard	Compliance
321	50	6	44	90%	12%

The standard for compliance is 90%. The Company's handling practices were below this standard.

Reason for Non-Replacement Exceptions:

42 of the files did not have sufficient suitability information to determine if the sale was suitable.

2 files were considered exceptions because they appear to be unsuitable sales.

A 67 year old male is moving \$32,287.52 to the Company. Net worth is listed as \$0-74,999K, which is too wide of a range to adequately determine financial situation. The premium is a high percentage of net worth. Annuitant indicated they only wanted to leave money in annuity for 4-8 years, which with a 10 year surrender period would generate a surrender penalty upon leaving.

30 year old male moving \$11K to the Company. He has less than \$10K in savings; net worth is between \$0-74,999K. He wants safety of premium, but selected an equity indexed annuity with 100% of money going to the fixed index account. The annuity was funded from the annuitant's company retirement plan, so he could be depleting resources that might provide a safer vehicle.

Replacements:

Population	Sample	Yes	No	Standard	Compliance
159	50	9	41	90%	18%

The standard for compliance is 90%. The Company's handling practices were below this standard.

Reason for Replacement Exceptions:

All 41 of the exception files did not have sufficient suitability information to determine if the sale was suitable.

It should be noted that the Company was asked at two different times to supply all suitability information to support the sale, once prior to the submission of the files. The other time was after the EIC reviewed the information submitted and determined that the suitability information that had been sent was not sufficient to support documentation.

Additional Exam Findings:

During the replacement file review, surrender charge information from the prior company was not consistently provided. The surrender charges applied to the replaced annuity is a major factor in determining suitability and if this information is not provided, the agent and the Company are not in a position to make a thorough evaluation of the recommendation.

The 'Suitability Acknowledgement for Annuity Sales' form 9849 (0608) includes a paragraph in Section B. 'Agent Acknowledgement' section that requires the agent to "*maintain and make available upon request to the insurer or the insurance commissioner, records of the information collected and other information as used as the basis for this insurance recommendation for at least 5 years after the insurer completed the recommended transaction*". However, OAC 3901-6-13 (J)(1) requires that this information be maintained for 8 years after the transaction is completed. The Company has indicated that they are in the process of updating their suitability form to include the correct requirement period.

The 'Fixed Annuity Fact Finder' form 9865 (0508) used by the Company for suitability purposes prior to January, 2010, has a couple of areas that require brief comments. Under Section B. 'Financial Profile' #3 the estimated net worth has margins that are too wide for the different categories. Smaller ranges would provide a clearer picture when reviewing suitability. Also, #5 for the type of investments and insurance products owned by the annuitant, would be more effective if dollar amounts were included, rather than just a check box.

Company Comments:

Beginning in January 2010 the Company has enhanced its suitability process, establishing the 'Fixed Annuity Suitability Plan ("FASP")', for handling suitability, along with a new suitability form. Policies have also been developed that agents must follow to assure compliance with statutes. The procedures are very detailed, with specific information on "red flags" to watch for, and include an annual audit plan for 2010 and 2011 (the procedures are for fixed and indexed annuities; the Company will still rely on broker/dealers review of suitability on variable products). The new form is comprehensive and provides the information needed to determine if a sale is suitable.

Unreported Replacements:**Examiner Observations:**

A review of the Company's replacement register and applications was conducted to check for any unreported replacements. There were four policies found that were marked as replacements on the applications, but were not included in the replacement register. All four involved situations in which the Company handled the transaction as a replacement, but did not include it on the register. These are all considered violations of OAC 3901-6-05(G)(1). Two of these were removed from the sample review because they involved 403b situations, but they were still considered exceptions. The Company also identified four files as NON-replacements, but these files were included in the replacement register. However, the file review supported that three of these were actually replacements but were misidentified by the Company.

Examiner Recommendations:

The Company should establish procedures and controls on replacement handling to assure compliance with OAC 3901-6-05(G) (1).

COMPLAINT HANDLING

Standard: Complaint Handling

The regulated entity takes adequate steps to finalize and dispose of the complaint in accordance with statutes, rules, regulations, and contract language.

Examiner Observations:

A review was conducted on all 16 complaints received by the Company in 2009 through June 2010 to assure handling in a timely manner and to determine if any analysis was completed for trends that might need attention. Of the 16 complaints, 13 involved one agent, Terri Dandino, who requested termination due to retirement from the industry. Her contract was terminated March 9, 2010. No other significant problems were identified.

The Company advised the examiners that all complaints are handled in the compliance unit. Upon receipt, a complaint is logged into a compliance database. The Company has sufficient controls in place to assure that complaints are handled promptly and thoroughly. The Company conducts a quarterly analysis of the complaints to identify trends in agents, agencies, and circumstances.

This concludes the report of the market conduct examination of the Life Insurance Company of the Southwest. The examiners, Don Layson, Ben Hauck, Laura Price, and Rob Stroup, would like to acknowledge the assistance and cooperation provided by the management and the employees of the Association.



Don Layson
Examiner in Charge

June 29, 2011
Date

ATTACHMENT



Sandy Mollett

June 24, 2011

Mr. Don Layson, Examiner
Ohio Department of Insurance
50 West Town Street
Third Floor – Suite 300
Columbus, OH 43215

RE: Life Insurance Company of the Southwest – NAIC #65528
Market Conduct Examination – December 31, 2009
Response to DRAFT Report

Dear Mr. Layson:

Life Insurance Company of the Southwest (LSW) is pleased to respond to the DRAFT report of the Market Conduct Examination.

Effective January 1, 2010, LSW enhanced its suitability process, establishing the Fixed Annuity Suitability Plan (FASP). The FASP includes provisions for conducting suitability audits. LSW's Audit & Risk Services conducted an internal audit of the FASP in the first quarter of 2011 for the period January 1, 2010 – December 31, 2010. Results show compliance of the FASP procedures to be effective.

While the DRAFT report indicates two files in the review process to be unsuitable sales, we would like to offer our explanation as to why we feel these transactions were suitable sales. See attached explanations:

Case #A – Male, age 30
Case #B – Male, age 67

With regard to the brochure/disclosures, LSW Executives are of the opinion that adequate product presentation cannot always be covered in a two-page disclosure. We continue to believe the necessary level of disclosure depends on the complexity of the product. Indexed annuity products are more complex, which requires a higher level of explanation. We require the signatures of the applicants and the agents on the disclosure to ensure the applicant has read the disclosure and the agent have explained the contents of the disclosure. Our disclosure design is intended to provide the agents with a script to follow to ensure that major policy features are explained.

National Life Group® (NLGroup) is a trade name of National Life Insurance Company, Montpelier, VT, Life Insurance Company of the Southwest (LSW), Dallas, TX and their affiliates. Each company of NLGroup is solely responsible for its own financial condition and contractual obligations. LSW is not an authorized insurer in New York and does not conduct insurance business in New York.

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Ohio Department of Insurance

LSW believes itself to be among a minority of companies offering partial withdrawals as guaranteed benefits. Both partial withdrawals of values from the policy, in which the policy remains in force; and surrenders, in which the policy is terminated; are subject to the charges (to the extent the withdrawn values exceed contractual allowances). Thus, the term "withdrawal charge" is more appropriate, and this is the terminology LSW adopted quite some time ago in order to make this clearer to the policy owner.

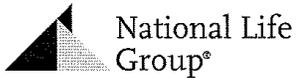
Using the same terminology in disclosure forms facilitates comparison between the disclosure and the policy form itself, whereas the introduction of a term not found in the policies would invite confusion.

Regarding record retention, all policy file documents are permanently retained, including all suitability related documents received by LSW. We are in the process of modifying our suitability form to include the record retention guidelines, which also require agents to retain the information obtained for the basis of a sale in their records for the required period of 8 years.

Best Regards,

A handwritten signature in cursive script that reads "Sandy Mollett /mlf".

Sandy Mollett, Director
Market Conduct & Compliance
Life Insurance Company of the Southwest



**Life Insurance Company of the Southwest
Ohio Market Conduct Examination – December 31, 2009**

**Case #A
Male – Age 30 (Non-Replacement)**

The source of premium for the 10 year Equity Indexed Annuity (IRA) was a 401(k) rollover. According to the Fixed Annuity Fact-Finder included in the application file, the policy owner reported income of \$50,000-74,999 at the time the application was taken. He also disclosed savings and investments of less than \$10,000.

The 401(k) appears to represent a large portion of the policy owner's liquid net worth. However, this is not unusual for someone in their thirties, still in their accumulation phase and attempting to build the value of their investment(s). An IRS-imposed penalty of 10% would apply to liquidation of an account regardless of how the funds are invested.

Policy owner selected "no" to both questions on the Important Notice: Replacement of Life Insurance or Annuities form, indicating that the premium did not come from an insurance product. As such, it is possible that the 401(k) could have been invested in securities products, including but not limited to mutual funds or stock. The response on the Fact-Finder also indicates the only investment experience the policy owner has is through investments in mutual funds and savings account deposits. The overall purpose of the policy as disclosed on the Fact-Finder is "Safety of Principal".

The answers to the questions on the form "Is This Annuity Right For You" also suggest the policy owner understood the policy is a long-term product, and that he did not intend to take withdrawals outside of the free amount associated with the policy.

The annuity appeared to be suitable for the policy owner at the time the application was taken despite the fact that the premium was a significant portion of his liquid net worth.

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**Life Insurance Company of the Southwest
Ohio Market Conduct Examination – December 31, 2009**

**Case #B
Male – Age 67 (Non-Replacement)**

The source of premium for this 10 year fixed annuity was a transfer from an American Funds IRA account (Balanced and Growth Funds, B Shares). The financial information completed on the Fixed Annuity Fact-Finder indicates that the premium amount may have been a significant portion of the policy owner's liquid net worth. However, his primary purpose in purchasing the policy was to secure safety of principal and stable growth. The American Funds account would not necessarily satisfy these objectives. The Fact-Finder also discloses that he has access to additional funds in case of emergency.

The policy owner discloses his time frame for withdrawal as 4-8 years, which is still within the withdrawal charge period associated with the policy. However, policy owner would have to take withdrawals from an IRA in order to satisfy his Required Minimum Distributions approximately four years from issue of the policy. Based on the financial information provided on the Fact-Finder, it is reasonable to assume he would need to take RMDs from the policy. He would not incur a withdrawal penalty for these withdrawals.

Under our new procedures for documenting suitability, we would have requested additional information from the agent regarding policy owner's liquid net worth and his withdrawal requirements in order to fully document the suitability of the sale. Despite the lack of financial data, this policy does not appear to be unsuitable based on his objectives of continued tax deferred growth at a fixed rate with principal protection.

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**STATE OF OHIO
DEPARTMENT OF INSURANCE
50 WEST TOWN STREET
3RD FLOOR, SUITE 300
COLUMBUS, OHIO 43215**

IN THE MATTER OF:
LIFE INSURANCE COMPANY : CONSENT ORDER
OF THE SOUTHWEST :
MARKET CONDUCT :
EXAMINATION :

The Superintendent of the Ohio Department of Insurance (“Superintendent”) is responsible for administering Ohio insurance laws pursuant to Ohio Revised Code (“ORC”) Section 3901.011. Life Insurance Company of the Southwest (“Company”) is authorized to engage in the business of insurance in the State of Ohio and as such is under the jurisdiction of the Superintendent. The Superintendent conducted an examination of the Company’s annuity suitability oversight and compliance from March 1, 2007 through December 31, 2009 to ensure compliance with Ohio law.

As a result of the examination the Department alleges deficiencies in the following areas:

- A) The Company failed to maintain documentation in its records that would establish reasonable grounds for suitability as required by Ohio Administrative Code (“OAC”) 3901-6-13 (G) and (J).
- B) The Company failed to use disclosures that were compliant with OAC 3901-6-14.

In lieu of further civil administrative proceedings and to resolve this matter, the Superintendent and Company hereby agrees to the following:

1. The Company shall establish and maintain a system and to supervise all compliance with Ohio statutes and rules concerning suitability and oversight of annuity purchases in accordance with OAC 3901-6-13 as revised effective July 1, 2011.
2. The Company shall design an Annuity Disclosure form that is compliant to OAC 3901-6-14.
3. The Company shall provide to the Superintendent for approval a written corrective action plan for compliance with the terms of this Consent Order within thirty (30) days of its execution by the Director.

The Company hereby waives its rights to a public hearing and appeal of this order pursuant to ORC Chapter 119.

The Company waives any and all causes of action, claim or rights, known or unknown, which it may have against the Department, and any employees, agents, consultants, contractors or officials of the Ohio Department of Insurance, in their individual and official capacities, as a result of any acts or omissions on the part of such persons or firms.

This is a public record and shall be entered into the Journal of the Ohio Department of Insurance.

Date: 7/25/2011

Signature: Sandra L. Mollett

Name (Printed): Sandra L. Mollett

Title: Director - Market Conduct & Compliance

Life Insurance Company of the Southwest

Date: 8/10/11

Mary Taylor
Mary Taylor
Lt. Governor/Director
Ohio Department of Insurance



National Life
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Sandy Mollett

July 25, 2011

Mr. Dan Atkisson, Insurance Compliance Supervisor
Ohio Department of Insurance
50 West Town Street
Third Floor – Suite 300
Columbus, OH 43215

RE: Life Insurance Company of the Southwest – NAIC #65528
Market Conduct Examination – December 31, 2009
Consent Order

Dear Mr. Atkisson:

Life Insurance Company of the Southwest (LSW) is pleased to submit our signed Consent Order to the above referenced Market Conduct Examination.

With regard to the brochure/disclosures, LSW retains the opinion that our brochure/disclosures are in compliance, as you also indicated in the draft report dated May 26, 2011. We believe that adequate product presentation cannot always be covered in a two-page disclosure. Additionally, the necessary level of disclosure depends on the complexity of the product. Indexed annuity products are more complex, which requires a higher level of explanation. We require the signatures of the applicants and the agents on the disclosure to ensure the applicant has read the disclosure and the agent have explained the contents of the disclosure. Our disclosure design is intended to provide the agents with a script to follow to ensure that major policy features are explained.

While LSW acknowledges your recommendations as outlined in the draft report; however, if the applicant does not read the document in its entirety, LSW requires the agent to explain the brochure/disclosures to the applicant fully and provide us with his signature.

Additionally, effective January 1, 2010, LSW enhanced its suitability process, establishing the Fixed Annuity Suitability Plan (FASP), which includes provisions for conducting suitability audits

It has been our pleasure to work with you and the Ohio Department of Insurance.

Best Regards,

Sandy Mollett, Director
Market Conduct & Compliance
Life Insurance Company of the Southwest

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