MEMORANDUM

To: Life Insurance and Annuities (A) Committee
From: Contingent Deferred Annuities (A) Working Group
Date: February 2013
Re: Contingent Deferred Annuities Working Group Findings

The Contingent Deferred Annuity ("CDA") working group was charged with evaluating the adequacy of existing laws and regulations as applied to CDAs and whether additional solvency and consumer protection standards are required. This work was built on the previous working group’s findings; among them that CDAs were a hybrid life product and should be sold by life insurers. In the course of completing its charges, the CDA working group met with and heard testimony from the life industry, interested trade groups, consumer representatives, the U.S. Securities and Exchange Commission ("SEC"), the Financial Industry Regulatory Authority ("FINRA"), the U.S. Department of Labor, the American Academy of Actuaries ("AAA"), and the National Organization of Life & Health Guaranty Associations ("NOLHGA") among other interested parties. The working group’s findings are based on the information provided by these parties and the working group’s review of existing NAIC model laws and regulations.

**Defining a CDA**

The working group determined that it would be useful in completing its charge to develop a uniform definition of a CDA for regulators, the industry, and consumers. The working group will propose to the A Committee that CDA’s be defined as “an annuity contract that establishes a life insurer’s obligation to make periodic payments for the annuitant’s lifetime at the time designated investments, which are not owned or held by the insurer, are depleted to a contractually-defined amount due to contractually-permitted withdrawals, market performance, fees and/or other charges.” The working group believes that this definition captures a CDA’s basic design structure.

In this regard, a CDA can be generally thought of as a living benefit added to a separately managed retirement account, for example a mutual fund. A CDA has three distinct phases. First, the CDA goes through an accumulation phase during which the amount of the CDA’s guaranteed annual payment is determined. This phase occurs from the time the CDA is purchased until the time the participant decides to take withdrawals from the separately managed account. The amount of the CDA benefit is set as a percentage of the total assets in the separately managed account. As those assets increase in value (for example through investment gains or additional deposits), the CDA benefit amount increases. However, once a benefit amount has been set, the CDA guarantees that the benefit amount can never decrease due to
investment losses. In other words, should the underlying assets decrease in value due to poor market performance, the CDA’s benefit amount does not decline.

The second phase of a CDA is the withdrawal phase in which the participant begins to draw funds from the separately managed account most typically upon retirement. During the withdrawal phase no benefit payments are made under the CDA. The CDA contract sets a maximum periodic withdrawal amount that a participant may take. Withdrawals at or below those permitted by the contract do not affect the benefit level established in the accumulation phase. However, should a participant withdraw funds above the contractually permitted amount, the amount of benefits available under the CDA decreases, potentially all the way to zero.

The third and final phase is the payout or settlement phase. Upon exhaustion of the separately managed account, the CDA begins making periodic benefit payments until the participant’s death. The amount of those payments is based upon the benefit amount set during the accumulation phase less any penalties or reductions for withdrawals above the contractual limits during the withdrawal phase. It is the working group’s understanding that CDA products sold to date do not include a death benefit.

**CDAs and Federal Regulation**

The SEC has not taken a position regarding whether CDAs are required to be registered as securities. However, based on information the SEC shared with the working group in November, it is the working group’s understanding that a product that is a derivative of a registered security is also considered a security requiring registration. Since a CDA’s value derives from the value of an underlying registered security, it would appear that CDAs need to be registered with the SEC. It is the working groups understanding, based on our discussions with the life industry, that insurers have been registering CDA products with the SEC to date. The working group believes that companies should continue to register CDA products with the SEC as securities unless registration is explicitly exempted.

Products registered with the SEC may only be sold through a FINRA licensed broker dealer or a registered investment advisor. Sales of CDAs by broker dealers are subject to FINRA’s general suitability requirements and investment advisors owe a fiduciary duty to their clients in recommending any investment product. Registered CDAs are subject to SEC disclosure requirements, including a prospectus, and FINRA’s advertising and marketing rules.

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1 The working group notes that CDAs offered through an ERISA retirement plan would be exempt from registration with the SEC and would be subject to regulation by the U.S. Department of Labor. The working group also notes that ERISA imposes a fiduciary duty on plan sponsors toward plan participants.

2 Investment advisors who manage less than $100 million in assets must register in the state of their principal place of business and investment advisors managing assets of $100 million or greater must register with the SEC.
State Non-Financial Regulation

The working group examined existing consumer protection laws and regulations to determine how CDAs best fit within the current regulations that apply to fixed and variable annuities. In conducting this review, the working group determined that CDAs do not fit neatly into either one of these categories. For example, the value of a CDA is determined, in part, by the market performance of the underlying assets, similar to how the value of a variable annuity is determined by the performance of a separate portfolio. Further, CDAs are subject to federal securities regulation much like variable annuities. On the other hand, a CDA also resembles a fixed annuity in that a CDA benefit is fixed, periodic payments upon annuitization. Additional confusion has been caused by CDA products being filed with states as both fixed and variable annuities.

Because a CDA shares qualities of both a fixed and variable annuity, the working group believes that a CDA should not be classified in either category but instead belongs in its own category. As such, the working group is recommending that CDAs be filed with the states as a “CDA” and not a fixed or variable annuity. The working group is mindful that changes to the System for Electronic Rate and Form Filing (“SERFF”) and state regulations may be necessary to implement this recommendation.

Because CDAs do not fit neatly within existing categories, the working group is reviewing which non-financial regulations should apply or not apply to CDAs and will make recommendations to the A Committee accordingly.

Financial and Solvency Regulation

The AAA has found that current capital and reserving requirements as set forth in AG43 and C3P2 are applicable to CDAs. The AAA has also stated that the issuance of CDAs require strong, comprehensive risk management practices by insurers and review of those risk management practices by state regulators. The working group acknowledges the AAA’s findings that current capital and reserving requirements as set forth in AG43 and C3P2 are applicable. Because this working group lacks the requisite expertise and resources to evaluate financial solvency issues, a detailed review of capital and reserving requirements has not been undertaken by this working group. However, the working group notes that AG43 and C3P2 are Principles Based guidelines that are subject to credits for a “clearly defined hedging strategy” and therefore evaluation of the capital and reserving requirements for CDAs should be ongoing at the NAIC level, and states will need to monitor the actuarial assumptions, hedge effectiveness, and the adequacy of enterprise risk management used by insurers issuing CDAs.

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3 The Own Risk and Solvency Assessment (“ORSA”) Model Act may provide a framework for states to monitor CDA issuers enterprise risk management.
Guaranty Fund Coverage

The working group received testimony from NOLHGA regarding its review of whether CDA’s would be covered under the NAIC Life and Health Insurance Guaranty Association Model Act (#520) (“GA Model Act”). NOLHGA indicated that their review is not complete but stated that it appeared that CDAs were eligible for coverage under the GA Model Act subject to a number of caveats and possible limitations. The working group also notes NOLHGA’s statement that individual guaranty fund coverage is ultimately a state by state determination.

The working group has not analyzed whether CDAs are covered under the GA Model Act and does not believe it is the appropriate venue for such a review. The working group will recommend that the A committee direct the appropriate NAIC Committee, Task Force or Working Group to review the definition of CDAs and the other findings of this working group and determine whether amendments to the GA Model Act are needed and prudent.