

## MEMO

TO: Jolie Matthews, NAIC Senior Health and Life Policy Advisor and Counsel  
FROM: Brenda J. Cude and Karrol Kitt, NAIC Consumer Representatives  
RE: Suitability in Annuity Transactions Model Regulation  
DATE: September 17, 2009

We wish to begin by thanking the working group for the time and energy expended thus far on behalf of consumers. We look forward to continuing to work with the group to further consumer interests in annuity sales.

Our comments are based on the September 2, 2009 draft of the model regulation.

**Section 5 G** includes a list of suitability information. We have commented previously that we find the list “curious;” we believe the list should be based on the financial planning process, which is:

1. Analyze the current financial position
2. Develop financial goals/objectives
3. Identify and evaluate strategies to achieve those goals
4. Establish and implement the plan
5. Reevaluate and revise the plan as needed.

Operating from that basis, we would suggest the list in Section 5 G be:

- Current financial position, including but not limited to information about assets and liabilities, net worth, income, any anticipated disruptions in future income (e.g., retirement), expenses (including payroll deductions), and any anticipated future changes in expenses (e.g., increased health care costs)
- Financial objectives, including those to be achieved by the purchase of an annuity. Information relevant to financial objectives includes but is not limited to age, liquidity needs, investment experience, investment objectives, risk tolerance, investment time horizon, tax status, and potential impact of an annuity on eligibility for benefits
- Source(s) of funds for purchase of an annuity, including specific information about any financial product the annuity would replace
- Any other information the insurer requires the insurance producer to consider prior to making a recommendation.

However, assuming that the working group’s preference is to use the existing list in Section 5 G, we wish to specifically challenge one item – liquid net worth. We know of

no such concept in family financial planning. We're familiar with net worth and liquidity, but not liquid net worth. At a minimum if this item is to be retained, we recommend a definition be added in Section 5. We can't write one, as we don't know what it means.

**Section 6A (1)** indicates the consumer should be informed *in general terms* (emphasis added) about various items. We are not clear about what is meant by "in general terms." Does it mean not specific to the annuity product? Or, does it mean about the various items as they relate to the product being considered but without the details – e.g., there is a surrender charge period but not how long it is? Greater clarity on this would seem to have value.

Section 6A (1) also lists various items about which the consumer must be informed. A very obvious one seems to be missing – what an annuity is. We would suggest adding this.

Also in **Section 6A (1)** the word "redeems" is used (i.e., "if the consumer sells or redeems the annuity"). We aren't familiar with this term as it applies to annuities. Perhaps it *is* commonly used but it is a word that never appears in any of the three annuity buyers guides.

In **Section 6A (3)** we believe the first phrase is specific to variable annuities and should be amended as such – "The particular annuity as a whole, the underlying subaccounts to which funds are allocated at the time of a purchase or exchange involving a *variable* annuity..."

In **Section 6A (4) (a) and (b)**, we suggest minor revisions to complete thoughts and make the intention clearer.

- (a) The consumer will incur a surrender charge, be subject to the commencement of a new surrender charge period, lose existing benefits (such as death, living or other contractual benefits), or be subject to increased fees, ~~investment advisory fees~~ or charges, including those for riders and similar product enhancements;
- (b) The consumer would benefit from product enhancements and improvements to be gained from an exchange; and

Finally, we note that this document places great faith in a common understanding of the word "reasonable." It (or reasonably) is used no less than 12 times in Section 6 alone. We hope that faith is not misplaced.

Underlining and overstrikes show the changes from the existing model. Comments are being requested on this draft. Comments should be sent by Sept. 17, 2009 to Jolie Matthews at [jmatthew@naic.org](mailto:jmatthew@naic.org).

## SUITABILITY IN ANNUITY TRANSACTIONS MODEL REGULATION

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### Section 1. Purpose

- A. The purpose of this regulation is to set forth standards and procedures for recommendations to consumers that result in a transaction involving annuity products so that the insurance needs and financial objectives of consumers at the time of the transaction are appropriately addressed.
  
- B. Nothing herein shall be construed to create or imply a private cause of action for a violation of this regulation.

**Drafting Note:** The language of subsection B comes from the NAIC Unfair Trade Practices Act. If a State has adopted different language, it should be substituted for subsection B.

### Section 2. Scope

This regulation shall apply to any recommendation to purchase or exchange an annuity made to a consumer by an insurance producer, or an insurer where no producer is involved, that results in the purchase or exchange recommended.

### Section 3. Authority

This regulation is issued under the authority of [insert reference to enabling legislation].

**Drafting Note:** States may wish to use the Unfair Trade Practices Act as enabling legislation or may pass a law with specific authority to adopt this regulation.

### Section 4. Exemptions

Unless otherwise specifically included, this regulation shall not apply to recommendations involving:

- A. Direct response solicitations where there is no recommendation based on information collected from the consumer pursuant to this regulation;
- B. Contracts used to fund:
  - (1) An employee pension or welfare benefit plan that is covered by the Employee Retirement and Income Security Act (ERISA);
  - (2) A plan described by sections 401(a), 401(k), 403(b), 408(k) or 408(p) of the Internal Revenue Code (IRC), as amended, if established or maintained by an employer;
  - (3) A government or church plan defined in section 414 of the IRC, a government or church welfare benefit plan, or a deferred compensation plan of a state or local government or tax exempt organization under section 457 of the IRC;
  - (4) A nonqualified deferred compensation arrangement established or maintained by an employer or plan sponsor;
  - (5) Settlements of or assumptions of liabilities associated with personal injury litigation or any dispute or claim resolution process; or
  - (6) Formal prepaid funeral contracts.

**Section 5. Definitions**

- A. “Annuity” means a fixed annuity or variable annuity that is individually solicited, whether the product is classified as an individual or group annuity.
- B. “FINRA” means the Financial Industry Regulatory Authority or a succeeding agency.
- C. “Insurer” means a company required to be licensed under the laws of this state to provide insurance products, including annuities.
- D. “Insurance producer” means a person required to be licensed under the laws of this state to sell, solicit or negotiate insurance, including annuities.
- E. “Qualified staff” means individuals who are:
  - (1) Qualified to perform a function required under this regulation; and
  - (2) Independent from insurance producers whose recommendations are the subject of the function and independent from the sales managers of the insurance producers.

- F. “Recommendation” means advice provided by an insurance producer, or an insurer where no producer is involved, to an individual consumer that results in a purchase or exchange of an annuity in accordance with that advice.
- G. “Suitability information” means information that is reasonably appropriate to determine the suitability of a recommendation, including the following:
- (1) Age;
  - (2) Annual income;
  - (3) Financial situation and needs, including the source of funding of the annuity;
  - (4) Investment experience;
  - (5) Investment objectives;
  - (6) Intended use of the annuity;
  - (7) Investment time horizon;
  - (8) Existing assets, including investment and life insurance holdings;
  - (9) Liquidity needs;
  - (10) Liquid net worth;
  - (11) Risk tolerance; and
  - (12) Tax status.
- H. “Suitability requirement” means [insert reference to this regulation and to State law or regulations that govern advertising, misrepresentation or disclosures related to sales of annuities] and, with respect to products subject to regulation by FINRA, FINRA rules governing the suitability of, or misrepresentation or disclosures in connection with, the sale of those products, including FINRA rules 2310 and 2821 or substantially similar FINRA rules.

**Comment [FaCS1]:** At a minimum, must be defined.

## Section 6. Duties of Insurers and of Insurance Producers

- A. In recommending to a consumer the purchase of an annuity or the exchange of an annuity that results in another insurance transaction or series of insurance transactions, the insurance producer, or the insurer where no producer is involved, shall have reasonable grounds for believing that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer as to his or her investments and other insurance products and as to his or her financial situation and needs, including the consumer’s suitability information, and that there is a reasonable basis to believe all of the following:
- (1) The consumer has been informed, in general terms, of various features of the annuity, such as the potential surrender period and surrender charge, potential tax penalty if the consumer sells or redeems the annuity, mortality and expense fees, investment advisory fees, potential charges for and features of riders, insurance and investment components and market risk;
  - (2) The consumer would benefit from certain features of the annuity, such as tax-deferred growth, annuitization or death or living benefit;

**Comment [FaCS2]:** It’s unclear what this means.

**Comment [FaCS3]:** Is this the correct term?

- (3) The particular annuity as a whole, the underlying subaccounts to which funds are allocated at the time of a purchase or exchange ~~involving a variable~~the annuity, and riders and similar product enhancements, if any, are suitable (and in the case of an exchange, the transaction as a whole is suitable) for the particular consumer based on his or her suitability information; and
  - (4) In the case of an exchange of an annuity, the exchange is suitable including taking into consideration whether:
    - (a) The consumer will incur a surrender charge, be subject to the commencement of a new surrender charge period, lose existing benefits (such as death, living or other contractual benefits), or be subject to increased fees, ~~investment advisory fees~~ or charges, including those for riders and similar product enhancements;
    - (b) The consumer would benefit from product enhancements and improvements to be gained from an exchange; and
    - (c) The consumer has had another annuity exchange within the preceding 36 months.
- B. Prior to the execution of a purchase or exchange of an annuity resulting from a recommendation, an insurance producer, or an insurer where no producer is involved, shall make reasonable efforts to obtain the consumer's suitability information.
- C. Except as permitted under subsection D, an insurer shall not issue an annuity recommended to a consumer unless the annuity is suitable based on the consumer's suitability information. The penalty for a violation of this subsection shall be reduced or eliminated if the violation is not part of a pattern or practice.
- D. (1) Except as provided under paragraph (2) of this subsection, neither an insurance producer, nor an insurer where no producer is involved, shall have any obligation to a consumer under subsection A or C related to any recommendation if a consumer:
- (a) Refuses to provide relevant information requested by the insurer or insurance producer, but there is a reasonable basis to believe the recommendation is suitable;
  - (b) Decides to enter into an insurance transaction that is not based on a recommendation of the insurer or insurance producer; or
  - (c) Fails to provide complete or accurate information.
- (2) An insurer or insurance producer's recommendation subject to paragraph (1) shall be reasonable under all the circumstances actually known to the insurer or insurance producer at the time of the recommendation.
- E. (1) An insurer shall establish a supervision system that is reasonably designed to achieve the insurer's and its insurance agency and insurance producers compliance with the suitability requirement, including, but not limited to, the following:

- (a) The insurer shall maintain reasonable procedures to require its insurance producers to comply with the training requirements of section 7 of this regulation;
  - (b) The insurer shall maintain reasonable procedures to verify consumer suitability information that supports a recommendation;
  - (c) The insurer shall issue a recommended annuity only if qualified staff review the recommendation and approved it as suitable based on the factors delineated in this section except an insurer may limit qualified staff review and approval to selected transactions by applying a system of selection criteria that is reasonably designed to prevent unsuitable recommendations;
  - (d) The insurer shall maintain reasonable procedures to monitor whether insurance producers have rates of effecting exchanges that raise for review whether the exchanges evidence conduct inconsistent with the suitability requirement;
  - (e) The insurer shall maintain reasonable procedures for qualified staff to examine, and report on, its insurance agencies at reasonable periodic intervals. The examination shall be designed to assist in detecting and preventing violations of this regulation. Nothing in this paragraph prohibits an insurer from accepting an examination conducted, and report certified, by an independent qualified firm; and
  - (f) The insurer shall annually provide a report to senior management, including to the senior manager responsible for audit functions, which details a review, with appropriate testing, reasonably designed to determine the effectiveness of the supervision system, the exceptions found, and corrective action taken or recommended, if any.
- (2) (a) A FINRA member broker-dealer supervision system that complies with FINRA suitability rules shall satisfy the insurer's supervision requirements under this subsection E.

**Drafting Note:** This paragraph is intended to grant a safe harbor to an insurer for the supervision system requirement under this subsection for annuity sales that are subject to the FINRA member broker-dealer required supervision system. The safe harbor applies to FINRA broker-dealer sales of fixed annuities as well as variable annuities.

- (b) An insurer shall:
    - (i) Monitor the FINRA member broker-dealer, using information collected in the normal course of the insurer's business; and
    - (ii) Provide to the FINRA member broker-dealer information and reports that are reasonably appropriate to assist the FINRA member broker-dealer to maintain its supervision system.
- (3) A general agent or independent agency shall establish a supervision system that is reasonably designed to achieve insurance producer compliance with the suitability requirement, including, but not limited to, reasonable procedures to require insurance producers to comply with section 7 of this regulation.

- (4) Nothing in this subsection restricts an insurer from contracting for performance of a function required under this subsection. An insurer remains responsible and liable for compliance with this subsection regardless of whether the insurer contracts for performance of a function.
- (5) An insurer, general agent or independent agency is not required to include in its system of supervision an insurance producer's recommendations to consumers of products other than the annuities offered by the insurer, general agent or independent agency.

F. An insurance producer shall not dissuade, or attempt to dissuade, a consumer from:

- (1) Truthfully responding to an insurer's request for confirmation of suitability information;
- (2) Filing a complaint; or
- (3) Cooperating with the investigation of a complaint.

G. A security representative recommendation of an annuity that is a security that complies with the FINRA rules pertaining to suitability shall satisfy the requirements under this section for the recommendation of annuities. However, nothing in this subsection shall limit the insurance commissioner's ability to enforce the provisions of this regulation.

**Drafting Note:** This subsection is intended to grant a safe harbor when a security representative recommendation of an annuity that is a security complies with the FINRA rules pertaining to suitability. This safe harbor applies regardless of whether the annuity/security is required to be registered a security.

#### **Section 7. Insurance Producer Training**

A. An insurance producer shall not solicit the sale of an annuity product unless the insurance producer has completed training on the material features of the annuity to the extent reasonably necessary to ensure the insurance producer has adequate knowledge of the product to recommend the annuity.

B. (1) An insurance producer, prior to soliciting the sale of an annuity, shall complete a one-time eight (8) credit training course approved by the department and provided by a department-approved education provider. The department shall consider any recommendations by the National Association of Insurance Commissioners for content of the required training course and shall use the following course outline:

- (a) Historical development of annuity contracts;
- (b) Types of annuities and various classifications of annuities;
- (c) Identification of the parties to an annuity;
- (d) How fixed, variable and indexed annuity contract provisions affect consumers;
- (e) The application of income taxation of qualified and non-qualified annuities;
- (f) Qualified plans and annuities;

- (g) The primary uses of annuities;
  - (h) The senior market;
  - (i) Appropriate sales practices;
  - (j) Reserving issues with annuity contracts;
  - (k) Consumer attitudes towards retirement; and
  - (l) Guaranty Fund role in relationship to annuities.
- (2) The satisfaction of the training requirements of another State that are substantially similar to paragraph (1) shall be deemed to satisfy the training requirements of paragraph (1) in this State.
  - (3) An insurance producer may, but is not required to, include credit for courses that meet the training requirements of paragraph (1) among continuing education credits submitted for the purpose of complying with the continuing education requirements under [insert reference to applicable State law or regulation governing continuing education].
  - (4) An insurer may satisfy its responsibility to require an insurance producer to comply with paragraph (1) by obtaining certificates of completion of the training course or obtaining reports provided by commissioner-sponsored database systems or vendors or from a reasonably reliable commercial database vendor that has a reporting arrangement with approved insurance education providers.

**Section 8. Mitigation of Responsibility**

- A. The commissioner may order:
  - (1) An insurer to take reasonably appropriate corrective action for any consumer harmed by the insurer's, or by its insurance producer's, violation of this regulation;
  - (2) An insurance producer to take reasonably appropriate corrective action for any consumer harmed by the insurance producer's violation of this regulation; and
  - (3) A general agency or independent agency that employs or contracts with an insurance producer to sell, or solicit the sale, of annuities to consumers, to take reasonably appropriate corrective action for any consumer harmed by the insurance producer's violation of this regulation.
- B. Any applicable penalty under [insert statutory citation] for a violation of section 6A, B, C or D of this regulation may be reduced or eliminated [, according to a schedule adopted by the commissioner,] if corrective action for the consumer was taken promptly after a violation was discovered.

**Drafting Note:** A State that has authority to adopt a schedule of penalties may wish to include the words in brackets. In that case, "shall" should be substituted for "may" in the same sentence.

**Section 9. [Optional] Recordkeeping**

- A. Insurers, general agents, independent agencies and insurance producers shall maintain or be able to make available to the commissioner records of the information collected from the consumer and other information used in making the recommendations that were the basis for insurance transactions for [insert number] years after the insurance transaction is completed by the insurer. An insurer is permitted, but shall not be required, to maintain documentation on behalf of an insurance producer.

**Drafting Note:** States should review their current record retention laws and specify a time period that is consistent with those laws. For some States this time period may be five (5) years.

- B. Records required to be maintained by this regulation may be maintained in paper, photographic, microprocess, magnetic, mechanical or electronic media or by any process that accurately reproduces the actual document.

**Drafting Note:** This section may be unnecessary in States that have a comprehensive recordkeeping law or regulation.

**Section 10.      Effective Date**

The amendments to this regulation shall take effect six (6) months after the date the regulation is adopted or on January 1, 2012, whichever is later.