<u>**DRAFT**</u>

GUIDANCE FOR THE FINANCIAL SOLVENCY AND MARKET CONDUCT REGULATION OF INSURERS WHO OFFER CONTINGENT DEFERRED ANNUITIES

Executive Summary

In late-2012, the Life Insurance and Annuities (A) Committee (the “A Committee”) charged the Contingent Deferred Annuity (“CDA”) Working Group with evaluating the adequacy of existing laws and regulations with regard to CDAs and whether additional solvency and consumer protection standards were required. The CDA Working Group determined that CDAs do not fit into the categories of fixed or variable annuities and, therefore, do not always easily fit in existing laws and regulations governing annuities.

The CDA Working Group developed this guidance to serve as a reference for states that are either interested in modifying their annuity laws to clarify their applicability to CDAs or to help states determine how to apply their existing annuity laws and rules to CDAs. This guidance sets forth the consumer protection and financial solvency model laws and regulations that should be applied to CDAs and those which should not apply to CDAs. The guidance outlines what revisions, additions, and regulatory interpretations a state may wish to consider in determining how existing state laws governing annuities apply to these products. This guidance also includes regulatory guidance developed by the Financial Condition (E) Committee, Life Risk-Based Capital (E) Working Group, and the Life Actuarial Task Force for states to use in evaluating capital and reserving requirements. This guidance is intended to provide a general framework for the regulation of CDAs while work on specific issues involving CDAs continues at the NAIC.

In the course of completing its charges, the CDA Working Group met with and heard discussion 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”), U.S. Government Accountability Office and the National Organization of Life & Health Guaranty Associations (“NOLHGA”) among other interested parties. This guidance is based on the information provided by these parties and the CDA Working Group’s review of existing NAIC model laws and regulations.

I. Background

A. Classification of CDAs

In 2012, the CDA Subgroup reviewed CDAs to determine how the product should be classified. In March 2012, the A Committee and the Executive Committee and Plenary adopted the recommendations of the CDA Subgroup that CDAs are annuities best written by life insurers.

B. Definition of CDAs

The CDA Working Group developed and the NAIC adopted a definition of a CDA 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." Regulators should consider this definition when determining whether a product is properly classified as a CDA. If revisions to statutes or regulations are contemplated, states may wish to add this definition in their statutes or regulations.

C. Features of a CDA

A CDA is an insurance product that provides protection against underperforming and downward performing markets in the form of an income guarantee on outside investment accounts owned by an insured. The insurer provides this income guarantee through the collection of on-going charges or fees from within these outside investment accounts. The insured[1] must agree to certain portfolio restrictions and must first deplete their outside investment account assets at the CDA guaranteed income amount and rate according to the contract and prior to the insurer's assumption of this amount.

CDAs are annuity products which transfer both investment risk and longevity risk to the insurers who issue them. A CDA can be generally thought of as a living benefit added to an investment account, such as a mutual funds or a managed account ("Covered Investments"). The underlying account is not held or managed by the insurer but is instead held by a related or unrelated third party. The insurer contractually restricts the type of Covered Investments that can be covered by the CDA, but the insurer does not control the Covered Investments. An example of this would be a CDA attached to a mutual fund held in an individual or employer-sponsored retirement account. The CDA issuer can contractually limit the CDA's attachment to certain allowable mutual funds, but would have no control over the assets that make up those mutual funds.

A CDA has three distinct phases during the life of the contract: accumulation, withdrawal, and payout. First, the CDA goes through an accumulation phase. This phase occurs from the date the CDA is issued until the time the insured decides to take withdrawals from the Covered Investments, typically upon reaching a certain age such as retirement age. During this phase, the CDA benefit base, a notional amount used for calculating permitted withdrawals and the benefit

[1] In these guidelines, "Insured" is used to refer generally to the person or persons who purchased the CDA benefit and is used synonymously with "consumer," "annuitant," "contractholder," etc.

amount, is typically determined by the value of the Covered Investments[2]. As those assets increase in value (for example through investment gains or additional deposits), the CDA benefit base amount increases. The CDA benefit base may also increase due to contractual features. Depending on the product design, the benefit base is calculated on a daily, monthly or annual basis. The more frequently the benefit base calculation is made, the more likely an insured will realize increases in the benefit base.

Once a benefit base amount has been set, the CDA guarantees that the benefit base can never decrease due to declines in the value of Covered Investments as the result of investment losses. This allows the insured to mitigate the risk that future withdrawal amounts will decrease due to market conditions. The insurer assumes some of the market risk of the Covered Investments by guaranteeing periodic withdrawal amounts based on the benefit base, which may be greater than the actual value of the Covered Investments held at the time of withdrawal.

The second phase of the CDA is the withdrawal phase. The withdrawal phase occurs when the insured elects to begin to draw funds from the Covered Investments after reaching the age specified in the CDA contract, most typically retirement age. Some product designs may allow insureds to elect to begin withdrawals at an earlier or later age, in which case, the percentage of the benefit base permitted for withdrawals may be adjusted up or down accordingly. During the withdrawal phase no benefit payments are made under the CDA and the insured is making withdrawals solely from the Covered Investments.

The "guaranteed withdrawal amount" under the CDA is the maximum withdrawal that an insured may take without penalty. Withdrawals at or below the guaranteed withdrawal amount do not affect the amount of future withdrawals. However, should an insured withdraw funds above the contractually permitted amount, a pro rata reduction of the CDA benefit base and/or the guaranteed withdrawal amount may occur. Excessive withdrawals could also result in termination of the CDA. Under current product designs, the guaranteed withdrawal amount is based on a specified percentage of the value of the CDA benefit base at the time distributions begin.

During the withdrawal phase, an insured still maintains his or her assets in the Covered Investments. Thus, the value of the Covered Investments may decrease during the withdrawal phase due to market conditions. However, the guaranteed withdrawal amount will not decrease due to loss of value of the Covered Investments though such losses could have the effect of triggering payments earlier under the CDA. Consequently, insurers will typically offer CDAs in connection with Covered Investments that can be effectively hedged and may also limit the type of assets a policyholder may hold in the Covered Investments during the withdrawal phase to those with low volatility.

[2] A benefit base could also be calculated as premium "rolled up" at a specified rate.

The third and final phase is the payout or settlement phase. Upon exhaustion of the Covered Investments, the insurer begins making periodic payments equal to the guaranteed withdrawal amount for the insured's lifetime[3]. In this way, the CDA guarantees lifetime income payments during retirement[4]. It is the Working Group's understanding that CDA products sold to date do not include a death benefit. Since an insured is limited in the amount of periodic withdrawals he or she may take during the withdrawal phase, whether or not a CDA will reach the payout or settlement phase is a function of the performance of the Covered Investments, increases to the CDA benefit base, insured behavior, and the insured's longevity[5].

For the CDA products that the Working Group reviewed, the fee for the CDA policy was calculated as a percentage of the Covered Investments or benefit base. Generally, the fee is deducted from the Covered Investments.

D. Federal Regulation of CDAs

The Securities and Exchange Commission ("SEC") has not taken a position regarding whether CDAs are required to be registered as securities under the Securities Act of 1933. However, based on information received from the SEC, it is the CDA Working Group's understanding that a product whose value derives from a registered security (e.g., a retail mutual fund that is registered with the SEC under the Investment Company Act of 1940) is also considered a security requiring registration unless a specific registration exemption applies. In cases where a CDA's value is derived from the value of an underlying registered security, it would appear that CDAs need to be registered with the SEC. It is the Working Group's understanding, based on its discussions with the life industry, that insurers have been registering CDA products with the SEC to date unless the CDA qualifies for one of the designated exemptions from SEC registration in the federal securities laws. An important exemption, for instance, is the exemption from SEC registration for annuities that fund certain retirement plans. CDAs structured as group annuities offered to 401(k) plans and similar plans typically rely on this exemption. Insurers should continue to discuss registration requirements for CDA products with the SEC.

Products registered with the SEC may only be sold through a FINRA licensed broker dealer or recommended by a Registered Investment Advisor[6]. Sales of CDAs through broker dealers are subject to FINRA's general suitability requirements. Registered Investment Advisors owe a fiduciary duty to their clients in recommending any investment product and a CDA purchase would be required to be made through a broker dealer. Registered CDAs are subject to SEC

[3] A payout structure could alternatively be based upon a joint life or "life with period certain" structure.
[4] Payments may be level or increasing depending upon product design.
[5] For some CDA products an insured may elect to purchase spousal benefits. In these instances the CDA would be subject to the longevity of both spouses.
[6] 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.

disclosure requirements, including the delivery of a prospectus, and FINRA's advertising and marketing rules.

II. Financial Regulation of CDAs

A. Risk Management

The design of CDAs and their relationship to investments outside of the insurer's control create risks that necessitate strong and comprehensive risk management practices by insurers. These risks include longevity risk, market risk, policyholder behavior risk, and third party risk.

Longevity risk is one of the main risks that CDAs transfer from the policyholder to the insurer. This is the risk that policyholders will live beyond their anticipated life expectancy, deplete their Covered Investments, and trigger the CDA lifetime income benefit. This risk can be managed by the insurer through product design, risk pooling, and risk management techniques that are similar to those used in other life products with longevity risk. Regulators reviewing an insurer's handling of longevity risk should look to the insurer's actuarial opinions to ensure that it is properly reserving for longevity risk.

Another risk that is transferred to the insurer from the insured is market risk. The market risk associated with a CDA is that the amount of benefit to the insured varies inversely to the market performance of the Covered Investments. The value of the Covered Investments may decrease while the benefit base and guaranteed withdrawal amount remain at a higher level. Under this scenario, when the insured takes the guaranteed withdrawal amount it will deplete the Covered Investments sooner and trigger the CDA benefit earlier then compared to an up market scenario. For example, a large downturn in the stock market could reduce the value of the Covered Investments underlying the CDA but the CDA benefit base would remain locked in at a higher value, thus increasing the likelihood that the CDA will reach the payout phase. Insurers can manage the market risk by developing comprehensive hedging strategies similar to those used to manage the market risk associated with other life and annuity products; that is, investing in an offsetting position in assets related to those in which the insurer incurs the market risk, i.e., derivatives. Of course, hedging cannot offset all market risks and is only a method for mitigating losses and results will vary depending upon hedge effectiveness. Further, in the event there is a significant, broad-based market downturn, such as the 2008 financial crisis, CDA issuers may see a greater than anticipated increase in the number of CDAs in the payout phase because of a high number of insureds suffering losses in the underlying Covered Investments. Regulators may wish to review an insurer's hedging strategy to verify that it is comprehensive, it appropriately addresses the insurer's market risks under adverse scenarios, and that an insurer is making reasonable assumptions regarding the effectiveness of the hedging strategy. An insurer must have a "Clearly Defined Hedging Strategy" to take credit for hedging in reserving (pursuant to Actuarial Guideline 43 ("AG 43")) and risk based capital calculations (pursuant to C-3Phase 2 ("C3P2")).

CDA issuers also incur risks based on insured behavior, including lapse rates, investment decisions, and the amount and timing of withdrawals. In this regard, the value of the CDA to an insured and, correspondingly, the level of risk to the insurer are in many ways governed by insured behavior. An insured may wish to place his or her assets in more volatile investments because if the investments increase in value, the increase is added to the CDA's benefit base, if the investments decrease in value, the benefit base is locked in at the portfolio's peak. From the insured's risk perspective, investment increases mean a higher benefit base and investment losses mean the CDA reaches the payout phase sooner.

Similarly, whether the payout phase will be reached also will depend in part on insured behavior, and in particular, when the insured commences withdrawals and whether the insured takes the maximum allowable withdrawal amount. An insured would achieve the maximum benefit under a typical CDA by taking the maximum allowable withdrawal amount each year in order to draw down the Covered Investments and trigger the payout phase of the CDA. Insurers can manage insured behavioral risk through product design including restrictions on the type of investment assets that an insured may use with a CDA, limiting withdrawals amounts during the withdrawal phase, varying fees in accordance with the risk level of the Covered Investments, and decreasing benefits in the payout phase for withdrawals above the guaranteed withdrawal amount during the withdrawal phase or for withdrawals made during the accumulation phase. Regulators should review CDA products with a balanced view, ensuring that CDAs are designed to manage insured behavior risks while not being overly restrictive in how insureds may use and gain value from a CDA.

Insurers who offer CDAs must also manage third party relationships and risks. Insurers establish the terms and conditions of the CDA but work with third party non-insurers who manage the Covered Investments. These third parties may collect the CDA fee, provide information regarding Covered Investments' performance (for determining the CDA benefit base), and notify the insurer if the insured changes the assets contained in the underlying account (to determine if the insured is invested in assets allowed under the CDA contract). If an insurer does not receive timely information from the third party asset manager, it will be difficult for the insurer to administer the CDA. Insurers will need to contract with these third-parties to clarify each party's roles and responsibilities. Similarly, insurers face counterparty risks from the parties from whom they buy hedge instruments, specifically, whether the counterparty will back the guarantees they offer.

The Financial Condition (E) Committee has been charged with developing a checklist for state regulators to use in reviewing the risk management program of insurers wishing to offer CDAs. Regulators may also wish to consider reviewing the insurer's risk management program within the framework of The Own Risk and Solvency Assessment ("ORSA") Model Act.

B. Risk Management Checklist

The Financial Condition (E) Committee has been charged with developing a checklist for state regulators to use in reviewing the risk management program of insurers wishing to offer CDAs. As of the date of adoption of these guidelines, work on this checklist was pending.

C. Reserve Requirements

The Life Actuarial (A) Task Force has determined that reserving for CDAs should be conducted in accordance with AG 43 and that no changes are needed or warranted to AG 43 to accommodate reserving for CDAs. It should be noted that CDAs may be considered, along with other similar products, in any future revisions to AG 43.

D. Capital Requirements

The Life Risked-Based Capital (E) Working Group has reached the preliminary conclusion that CDA capital requirements should be determined using C3 Phase II. As of the adoption of these guidelines, no changes to C3 Phase II were anticipated to address CDAs but changes may be considered after reviewing the work of other groups reviewing financial requirements for CDAs.

III. Non-Financial Regulation of CDAs

The CDA 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 Covered Investments, similar to how the value of a variable annuity is determined by the performance of a separate portfolio. Further, CDAs, if registered with the SEC, are subject to federal securities regulation. On the other hand, a CDA resembles a fixed annuity in that a CDA benefit consists of fixed, periodic payments upon annuitization or depletion of the underlying assets. 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 concluded that a CDA should not be classified in either category but instead belongs in its own category.

A. Filing Requirements

The CDA Working Group recommends that CDAs be filed with states as “Contingent Deferred Annuities” and not as fixed or variable annuities. Based on this recommendation, “Contingent Deferred Annuities” has been added as a filing category in the System for Electronic Rate and Form Filing (“SERFF”). In this regard, a group and individual category has been established for CDAs under type of insurance. (A07G Group Annuities – Special / A07G.003 Contingent Deferred and A07I Individual Annuities – Special / A.07I.003 Contingent Deferred.)

B. Application of NAIC Model Laws and Regulations

The Working Group reviewed which non-financial model acts and regulations should apply, or not apply, to CDAs. The Working Group's findings are outlined below along with recommendations about how states could interpret and/or amend their existing annuity laws and rules.

Producer Licensing Model Act (#218)

The Producer Licensing Model Act governs the qualification requirements and procedures for licensing insurance producers. The Producer Licensing (EX) Task Force has reviewed this Model and determined that "producers selling CDAs should be required to obtain a securities and variable lines license." The Task Force did not recommend any revisions to the Model. For CDAs that are registered as securities, regulators should verify that producers have the requisite licenses and registration required to sell securities.

Annuity Disclosure Model Regulation (#245)

The Annuity Disclosure Model Regulation requires insurers who sell annuities to provide a disclosure document and a buyer's guide in connection with the sale of an annuity. The Model applies broadly to all annuity contracts but exempts specific types of annuities including those registered with the SEC or issued to employer-sponsored retirement plans which may have their own disclosure requirements that preempt state law. See Section 3. Since CDAs generally fall within one of these two categories, the Working Group found that the exemption in the annuity disclosure model regulation for registered products and employer-sponsored plans would apply to CDAs. To the extent there are any CDAs products that do not fall within one of these two exceptions, the disclosure requirements outlined in Section 5.B. of the Model Regulation would apply.

Under the Model Regulation, the NAIC buyer's guide is required to be provided in the sales of variable annuities "and when appropriate, in sales of other registered products." Currently, the NAIC does not have a buyer's guide which addresses CDAs. Providing the current buyer's guide for fixed and variable annuities, which is inapplicable, for CDAs may confuse consumers. Therefore, the Working Group concluded that the requirement to provide a buyer's guide would not be appropriate for CDAs. A drafting note was added to the model regulation and adopted by the NAIC that states "[t]he requirement to provide a Buyer's guide would not be appropriate for contingent deferred annuities unless, or until such time as, the NAIC adopts a Buyer's Guide that specifically addresses contingent deferred annuities."

States should review their annuity disclosure laws and regulations to determine if they need to be revised to clarify when the disclosure requirements do not apply to CDAs. The NAIC has adopted a change to the model regulation that adds a definition of "registered products" and has added a drafting note that registered products would include registered CDAs. The model's exemptions for registered products and products issued to employer-sponsored plans may be broad enough for states to interpret existing law to exclude CDAs without revision to existing regulations.

Suitability in Annuity Transactions Model Regulations (#275)

The CDA Working Group determined that the Suitability in Annuity Transactions Model Regulation should apply to CDAs and that suitability review for the sale of CDAs is an important consumer protection for these products. Section 6. H.1 of the Model Act has a "safe harbor" provision that provides that sales made in compliance with FINRA requirements "pertaining to suitability and supervision of annuity transactions" satisfy the requirements of the Model Act. The NAIC adopted a revision to this section of the model to clarify that the safe harbor provision applies to all types of annuities which would include CDAs. Thus, if FINRA's variable annuity suitability rules are applied to registered CDAs or CDA specific suitability rules are developed by FINRA in the future, that suitability review would be considered to be in compliance with the Model Act.

That being said, FINRA indicated to the Working Group that it will not require that broker dealers apply the suitability standards for variable annuities to CDA sales, though FINRA general suitability requirements would apply. If a broker-dealer does not apply FINRA's annuity suitability standards to the sale of a CDA then the safe harbor provision would not be applicable and the suitability requirements of the Model Act would apply. However, individual broker-dealers may apply FINRA annuity suitability standards to CDAs, despite FINRA not requiring it, and that would be sufficient for the safe harbor provision to apply. State regulators should ensure that sales of CDAs are subjected to suitability review either under FINRA standards or state standards. If suitability review is not conducted under FINRA's suitability standards then the suitability requirements of the Model Act apply.

For sales governed by the Model Act, the Working Group concluded that the existing list of "suitability information" included in section 5. I. of the Act contains all the information that is needed to examine the suitability of a CDA sale and additional factors do not need to be added to the Model Act to specifically address CDAs. The NAIC also adopted changes to Section 7. of the Model Act, Insurance Producer Training, to clarify that training requirements would include the product specific features of all types of annuity contracts including CDAs.

Life and Health Insurance Guaranty Association Model Act (#520)

The Receivership and Insolvency (E) Task Force ("RITF") reviewed whether revisions to the model act were needed and warranted to address CDAs. After presentations from the National Organization of Life & Health Guaranty Associations ("NOLGHA"), discussions with taskforce members, and comments from interested parties, the RITF found that CDAs would fall within the definition of "annuity" in the Model Act and be subject to the same provisions for coverage, group and individual, and subject to the same limitations and broad exclusions, as other annuities. This finding was based on the assumption that CDAs are considered annuities under state law and the issuer is a member insurer under state guaranty association law.

Subject to the fact that individual state insurance departments and guaranty associations always have the ultimate decision of what contracts are covered, RITF has determined that, in those states that meet the above assumptions, CDAs should be covered annuities, both in the pre-payout phrase and the pay-out phrase, subject to all of the other statutory limits and exclusions that apply generally to annuities.

Advertisements of Life Insurance and Annuities Model Regulation (#570)

The Advertisements of Life Insurance and Annuities Model Regulation sets forth standards for the advertisement of life products. The CDA Working Group determined that this regulation is applicable to CDAs. This regulation currently applies to "annuities" which the group determined was broad enough to encompass CDAs. Section 3. A. of the model regulation states that where federal regulations establish disclosure requirements, this regulation is interpreted to avoid conflicts with federal regulation. The Working Group believes this section should also apply to CDAs when they are registered and subject to federal disclosure requirements. The NAIC has adopted a revision to this section to clarify that this section applies to all registered products which would include registered CDAs. States should review their existing regulations and consider clarifying their regulations or issuing guidance that this regulation would apply to CDAs. States may also wish to clarify that application of these regulations to registered CDAs is not intended to conflict with federal disclosure requirements to avoid issues of preemption.

Life Insurance and Annuities Replacement Model Regulation (#613)

The Life Insurance and Annuities Replacement Model Regulation regulates insurers and producers with respect to the replacement of existing life insurance plans and annuity contracts. The CDA Working Group concluded that the Model Regulation would apply to CDAs just like any other annuity. Section 1.C. of the Model Regulation exempts "registered contracts" with respect to the provision of illustrations and policy summaries because those products are subject to federal prospectus and disclosure requirements. The NAIC adopted revisions to the definition of "registered contracts" and a drafting note to clarify that this exemption would include registered CDAs that are subject to federal disclosure requirements.

Synthetic Guaranteed Investment Contracts Model Regulation (#695)

The Synthetic Guaranteed Investment Contracts Model Regulation prescribes terms and conditions under which life insurance companies can issue contracts that "establish the insurer's obligation by reference to a segregated portfolio of assets that is not owned by the insurer." The CDA Working Group made no findings regarding whether this model regulation would apply to CDAs but did note that CDAs share certain characteristics with Synthetic Guaranteed Investment Contracts. The A Committee tasked the Life Actuarial Task Force with reviewing this model and its relation to CDAs and the Task Force concluded that this model regulation should not apply to CDAs.

Standard Nonforfeiture Law for Individual Deferred Annuities (#805)

The Standard Nonforfeiture Law for Individual Deferred Annuities sets requirements and minimum values for surrender benefits due to a contract holder upon non-payment or cancellation of an annuity contract. The law applies broadly to individual annuities unless specifically exempted. Because the law broadly applies to annuities and CDAs are not specifically exempted, this law would arguably apply to CDAs. However, the CDA Working Group determined that it was unclear how nonforfeiture benefits would be calculated for CDAs under the current law as CDAs do not contain paid-up annuity, cash surrender, or death benefits, for example. Therefore, the CDA Working Group recommended that the current model be amended to specifically exclude CDAs as there is no method in the law for calculating nonforfeiture benefits as they would apply to CDAs. Thus, inclusion of CDAs in this model would cause confusion. The CDA Working Group made no recommendations as to whether nonforfeiture benefits should be required for CDAs. Proposed revisions to the model to exempt CDAs were pending at the NAIC as of the date of adoption of these guidelines.

Other Consumer Protection Issues

During the working group's review of CDAs, concerns were raised by working group members regarding scenarios where the CDA contract could be cancelled before the payout phase resulting in the loss of the CDA benefit. The working group identified two types of scenarios in which a CDA contract could be cancelled:

1. Cancellation of the contract as a result of action by the insured based on the terms of the contract. The most obvious examples of this would be an insured electing to surrender the CDA contract, failing to pay the CDA fees or violation the terms of the CDA contract.
2. Cancellation of the contract as a result of action by a financial institution (e.g. insurer, third party/investment manager).

This section focuses upon consumer protections triggered in the second type of scenario: cancellation of the contract for reasons beyond the control of the insured.

While we believe these scenarios would be uncommon, the cancellation of the CDA contract may be the result of actions of a financial institution.   For example, if the investment manager deviates for agreed upon investment parameters for a Covered Investments, the insurer can remove specific investments from its list of permitted investments.   In these instances, the insured will have the option to move their investments or face cancellation of the CDA contract. Additionally, insurers often rely on third parties to remit fees under the CDA contract and provide data regarding an insured's investments and withdrawals. Failure by a third party to perform one or more of these tasks may necessitate the cancellation of the CDA contract by the insurer[7].

The loss of the CDA benefit could come after years of paying fees for the CDA. In this regard, a CDA provides guaranteed lifetime income and like most other life products, the time between the insured entering the contract and collecting benefits could be years or decades. There is no payout of settlement phase until the Covered Investments have been exhausted and thus, a CDA that is cancelled in the accumulation or withdrawal phase would result in no periodic payments from the insurer. Further, CDA contract fees are most typically taken from the covered investments, so the insured not only loses the amount of fees paid but may also lose the potential investment gains that money would have generated had it not been subtracted from the Covered Investments. Thus, the cancellation of a CDA contract could result in a lower account value had fees not been assessed. It is important to remember that because the insurer does not hold or control the Covered Investments for a CDA, an insured always retains the entire amount of the Covered Investments in the event a CDA contract is cancelled. However, if no cancellation benefit is given, the insured could lose significant account value, future "peace of mind" benefits, and lifetime income protection.

As a result of the working group's concerns, the group asked the life industry to develop a cancellation benefit that could be made available to an insured when the cancellation is not a result of action taken by the insured. The life industry presented three types of cancellation benefits that could be offered to insureds. First, the life industry indicated that an insured could be offered a replacement annuity that generally replicated the CDA benefit accrued at the time of cancellation. The replacement annuity may be structured in several ways including:

- A single premium immediate annuity;
- A deferred income annuity; or
- A variable annuity with a guaranteed lifetime withdrawal benefit or a guaranteed minimum income benefit.

The insurer would design the replacement annuity to provide guaranteed annuity payments at the guaranteed withdrawal amount that was earned at the time of CDA cancellation. The type of annuity made available may depend on the stage the CDA is in at the time of cancellation.

[7] Other examples of cancellations caused by the actions of a financial institution include the expiration of the contract between the insurer and third party resulting in the CDA contract no longer supporting investments with that third party as a permitted Covered Investment. Another example may be an employer-sponsored retirement plan where the plan sponsor choses a new company to manage its employee's retirement accounts that has no contract with the CDA insurer. The insured's retirement funds would rollover into a retirement account that would not constitute a permitted Covered Investment.

The second type of cancellation benefit that could be made available to the insureds is a lump sum payment. The insured would receive a cash payment in an amount equal to the present value of the guaranteed withdrawal amount minus the CDA account value and present value of future fees at the time the CDA was cancelled. The present value of the guarantee would be determined according to a formula outlined in the CDA contract and filed with regulators.

The third type of cancellation benefit would be a return of a portion of the fees incurred by the insured. For this benefit, the insurer would return a percentage of the fee paid by the insured either in the form of a lump sum payment or alternatively could be paid out as a lifetime income stream payable immediately or when the payout phase of the CDA was anticipated to begin.

The particular benefit that is appropriate for a CDA contract will depend on the design of the specific CDA contract, the market where the CDA contract is sold and could vary based on other factors such as the transferability of the Covered Investments or whether the CDA is in the accumulation phase or withdrawal phase when the cancellation occurs. For example, the option to transfer investments to a variable annuity with a guaranteed income rider will depend on whether an insured could transfer their Covered Investments to the variable annuity and whether such a transfer would be suitable. In another example, a single premium immediate annuity may be more appropriate for a CDA cancelled in the withdrawal phase and a deferred income annuity may be more appropriate for a CDA cancelled in the accumulation phase. Different approaches to the cancellation benefit may be warranted to address the reasons and timing of the cancellation.

After reviewing the issue and hearing options from the industry as to how a cancellation benefit could be provided, the working group determined that a minimum cancellation benefit should be included in every CDA contract filed after the date these guidelines were adopted. With regard to when the cancellation benefit should be available, the working group determined that, at a minimum, a cancellation benefit should be available where a CDA contract is cancelled for reasons other than actions of the insured. This would include cancellation due to third party contractual issues between the insurer and the investment manager of the Covered Investments. This would address situations where the insured can no longer maintain a CDA benefit because the CDA contract does not cover their investments.

Each CDA contract should at a minimum contain a CDA cancellation benefit and regulators reviewing CDA cancellation benefits should ensure that at least one of the benefits is available to the insured. The Working Group acknowledges that one motivation for consumers purchasing a CDA may be a preference to keep their assets in an externally managed investment account, such as a mutual fund or managed account. Notwithstanding the ability of the consumer to maintain guaranteed lifetime income through an annuity cancellation option (e.g., variable annuity with guaranteed lifetime withdrawal benefits or guaranteed minimum income benefit, single premium annuity, deferred income annuity), limiting a consumer to this option may run contrary to their reluctance to transfer assets to an insurer. Therefore, the CDA Working Group recommends that when an insurer offers an annuity cancellation option, that a second option, at the insurers discretion, be made available to the consumer. This recommendation does not apply to CDAs offered through an employer-sponsored retirement account because the options available will be governed by the employer/fiduciary's contract with the insurer and regulations governing employer-sponsored plans. Regulators should allow insurers flexibility to design a cancellation benefit that best fits their particular product design. In addition, depending on product design, it may be appropriate for insurers to offer more than one cancellation benefit option, and which option is available may also vary depending on which phase the CDA contract is in at the time of cancellation.

In addition, the CDA contract provisions and any associated disclosure document should indicate the events that could lead to cancellation of the CDA contract. Also, the contract and associated disclosure document should specify what actions or events would lead to the insurer cancelling the CDA without providing a cancellation benefit. In addition, the CDA contract provisions and associated disclosure document should specify the scenarios where a cancellation benefit is available, an explanation as to the form of the cancellation benefit, and how the amount of the cancellation benefit is calculated. Examples drafted by the life industry are attached to these guidelines. The actual language filed in a product specific form filing will differ.

Regulators should enforce the requirement that a CDA contract include a cancellation benefit as a standard CDA contract requirement in each state's form filing checklists and filing guidelines. CDA form filings that do not contain a cancellation benefit that meets the minimum requirements outlined in these guidelines should be disapproved pursuant to each state's form filing laws and regulations. The working group's recommendation should be viewed as a minimum requirement for sale of this product and regulators should consider how a cancellation benefit would best fit within their state's requirements.