Suitability Requirements

The World of Evolving Annuity Products

By Anthony H. Pelle and Donna K. Knapton

It is imperative to understand the evolution of suitability, its applicability, and the potential dimensions of liability.

The concept of "suitability" as it applies to insurance-based or insurance-derived products, particularly annuities, has increasingly moved to the forefront of financial product litigation over the last 10 years. Plaintiffs allege that agents sold them policies that were "unsuitable" for them, and seek to cancel and recover damages resulting from the alleged sale of the "unsuitable" annuity product. The rise in suitability claims, and regulatory scrutiny of suitability of annuity products for customers, raises important questions for those selling and advising customers regarding these financial products.

With issues and potential liability under the suitability theory growing as once traditional insurance products have evolved and blurred the line between insurance and securities, it is imperative for financial professionals to understand: (1) the concept of suitability and its evolution to include certain insurance-based or insurance-derived products; (2) its applicability to particular insurance-based and insurance-derived products, such as annuities, that financial professionals recommend and sell to their customers; and (3) the dimensions of liability that attach to such recommendations.

What Is Suitability?

Simply put, suitability is a determination that based upon a customer's particular risk profile, other securities holdings, financial situation, investment objectives, and investment experience, that a financial product is appropriate for that customer. This necessarily requires an individual case by case, and product by product, determination.

The suitability determination by those selling or advising customers concerning certain insurance-based or insurance-derived products does not make the financial professional a guarantor of a product's performance. Instead, it is essentially a determination that at the point of sale, and at the point of any required periodic portfolio review, the product is consistent with the customer's risk tolerance, financial objectives, and financial situation.

The Evolution of "Suitability"

The concept of suitability originates in the securities context. With the U.S. stock mar-

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ket crash of 1929 and its financial aftermath, lawmakers jumped into action to protect investors and the U.S. securities markets. Over the next 10 years, the U.S. Congress created a vast body of securities statutes that would become the federal securities laws.

The two cornerstones upon which those laws were built are investor protection, and protection of the integrity of the U.S. securities markets. Imposing a "suitability" requirement upon financial professionals who recommend securities products was a logical component of the overall scheme to protect investors and the markets.

Strictly speaking, there is no "suitability" rule found in the federal securities laws, although where the conduct rises to the level of fraud, its various antifraud rules can apply. Rather it was the NASD and the New York Stock Exchange, whose regulatory arm combined with the NASD in July 2007 to form the Financial Regulatory Authority ("FINRA"), and other exchanges that adopted specific rules that impose suitability requirements on their members.

Registered broker-dealers must be members of FINRA. Thus, all registered broker-dealers are bound by NASD Conduct Rule 2310, which prohibits a broker-dealer and its associated registered persons from recommending securities to a customer unless the broker has reasonable grounds to believe that the securities are suitable for the customer's financial situation and needs. Although FINRA is currently consolidating the NASD and NYSE rule books, the new rulebook will most certainly contain a suitability rule.

As set forth in NASD Rule 2310, a broker-dealer must make reasonable efforts to obtain information concerning a customer's financial status, the customer's investment objectives, and other information considered to be reasonable by the broker-dealer in making a recommendation to the customer. Some of the characteristics that must be considered in determining customer suitability include: age, income, education, investment sophistication, source of income, and investment objectives. In fact, Rule 2310 imposes an affirmative duty on the broker-dealer to make reasonable efforts to obtain certain information to make a suitability determination prior to the execution of the recommended transaction. The information sought should include information concerning the customer's financial status, tax status, investment objectives, and any other information used or considered reasonable by the broker-dealer in making a recommendation to the customer.

When recommending securities to institutional customers, NASD Rule 2310-3 sets forth different factors that may be relevant when considering compliance with Rule 2310's suitability requirement. Under Rule 2310-3, a FINRA member's obligation to determine that a recommendation is suitable for an institutional client is fulfilled where the member has reasonable grounds for concluding that: (1) the customer is capable of independently evaluating the investment risk, due to its experience with the product and markets, and/or use of professional financial advisers; and (2) the customer is making an independent investment decision, as opposed to relying on the member's recommendation. If either of the factors do not apply, the member's specific obligations under the suitability rule are not diminished.

Investment advisers that are registered and regulated by either the U.S. Securities and Exchange Commission (SEC) or states, depending upon various factors, are similarly required to provide only suitable investment advice and recommendations. Investment advisers' suitability requirement springs from their fiduciary duty to clients, and the fact that they are subject to the Investment Advisers Act of 1940 (Advisers Act) antifraud provisions, rather than black letter rule. Investment advisers' suitability requirement is basically the same as that for broker-dealers, in that investment advisers must only recommend securities investments to a customer that they determine are appropriate in light of the customer's financial objectives, investment experience and financial situation. *See, e.g.*, Investment Advisers Act Release No. 1406 (March 16, 1994).

Suitability and Its Application to Insurance-Derived Products

Broker-dealer and investment advisers' suitability obligations, whether under FINRA and exchange rules or arising from an adviser's fiduciary duty, apply to recommendations involving securities. Thus, the starting point for evaluating whether broker-dealer or adviser suitability determinations apply to the recommendation of any given financial product is to first determine whether the recommendation involves a security.

The term "security" is defined in Section 2(a)(1) of the Securities Act of 1933 ("Securities Act"). 15 U.S.C. §77a *et seq.* Generally the term "security" encompasses those financial instruments traditionally understood to be a security, such as stocks, bonds, debentures, securities options, notes, and certain other specifically enumerated securities instruments. Section 2(a)(1)'s definition of a "security" also includes what essentially has become the catch-all category of "investment contracts."

> **Suitability rules** for insurance products vary by state, and one must reference each state's rules to ensure compliance with suitability requirements.

With wisdom and foresight, the 1933 U.S. legislature intentionally left certain terms in the federal securities laws undefined, and created certain enabling statutes instead of specific provisions in some instances so that those laws would be flexible and enduring. The 1933 legislature intended that the Securities Act would remain indefinitely relevant, and therefore drafted it so that its terms would encompass new and innovative products that enterprising financial professionals might create in the future. One of the terms it left undefined was the term "investment contract," which has become the catch-all category for those products that do not fit neatly into one of the traditional categories of securities but should fairly be deemed a security due to their securities-like characteristics.

With respect to the defining what an investment contract might be, the U.S. Supreme Court stepped in where Congress

left off. In 1946, the Supreme Court handed down its decision in *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946). Although the *Howey* decision does not set forth a definitive definition of an "investment contract," the Supreme Court did create a four-part test for analyzing whether a particular financial instrument is an "investment contract," and therefore, a security. The test is whether

Once determined to be a security, variable annuities became subject to the registration and other requirements imposed by the federal securities laws.

an instrument or scheme: (1) involves an investment of money; (2) in a common enterprise or pool that combines the investor's funds with that of other investors; (3) is done for the purpose of deriving profits; and (4) with profits coming solely from the efforts of others (*i.e.*, the investor is completely relying on others to do the actual work or operations management necessary to create the profits).

It is primarily from the investment contract category that the definition of a security has grown to encompass products developed by insurance companies and professionals in the 20th and 21st Century. Throughout the mid-20th Century, the insurance industry took notice of the expanding needs of insurance customers beyond what traditional insurance products, such as whole and term life insurance, could offer their clients. Enterprising insurance industry professionals recognized this need and began developing new products based upon, but not wholly like, the traditional insurance products they had been offering to their customers. As a result, the annuity was born in the late 1930s and annuity legislation was enacted.

As first conceived, annuities basically provided a personal pension plan, and were created with the idea that they would provide retirement income for annuitants in addition to Social Security payments. A person purchasing an annuity ("annuitant") would pay in a set sum of money, either in a lump sum or in installments in the form of premiums. After a set period of time, the issuer of the annuity contract would pay out a set amount of money or "benefits" over a specified period of time, usually until the death of the annuitant. That payment would include appreciation or an "investment return" on the initial paid-in amount, much like interest on a bond or bank certificate of deposit (CD). Although annuities now come in different flavors, these simple guaranteed return annuities first created in the early 1930's are what is commonly known as a fixed annuity.

Fixed Annuities

With fixed annuities, the annuity purchaser receives some sort of minimum guaranteed rate of return on the face amount of the contract, much like a bank CD. Many fixed annuities link the rate of return to a variety of market indices or market interest rates, which allow for the purchaser to receive more than the minimum guaranteed rate when interest rates are high. At all times, however, the purchaser receives at least the guaranteed minimum rate of return and rate of fixed income over the term set forth in the contract. In that way, the guaranteed minimum return rate acts as a "floor," and the insurer assumes the risk of paying the minimum rate of fixed income or fixed benefits to the annuitant, even if market interest rates are below the guaranteed minimum rate at the time payout is due.

Because the insurance company assumes the risk of paying out at least some guaranteed minimum return upon specified conditions, the fixed annuity acts like a traditional insurance product by insuring the contract purchaser against risk of loss of all of the annuity income or "benefits" in a down market. As a result, fixed annuities are generally characterized as insurance products, regulated as insurance products, and exempt from the Securities Act's provisions pursuant to Securities Act Section 3(a)(8) which exempts insurance policies and annuities that are regulated pursuant to an insurance, banking, or similar regulatory scheme.

Suitability rules for insurance products vary by state, and one must reference each state's rules to ensure compliance with suitability requirements. The National Association of Insurance Commissioners (NAIC), the voluntary organization of insurance regulators from the 50 states, the District of Columbia and the five U.S. Territories, has issued the Suitability in Annuity Transactions Model Regulation 275. Model Regulation 275 is the main formal NAIC document setting forth suitability standards for annuity products. Many states either have wholly adopted it, or have adopted it with modifications to provide targeted protection for certain groups such as senior citizens. There still are many states and territories, however, which have taken no action with respect to Model Regulation 275. These include Alabama, District of Columbia, Hawaii, Kentucky, Maryland, Mississippi, Nebraska, New Hampshire, New Mexico, New York, Ohio, Pennsylvania, Puerto Rico, Tennessee, Vermont, Virgin Islands, Virginia, and Washington.

Although most states regulate fixed annuities only as insurance products, state securities laws and attendant suitability requirements can attach in some states. There are at least two states that have no exclusions in their securities statutes for fixed insurance products, despite the federal exemption for certain insurance and annuity contracts found in Section 3(a)(8) of the Securities Act. Therefore, state securities laws should be reviewed in addition to state insurance regulations to determine the scope of suitability requirements for a particular life insurance policy or fixed annuity.

Variable Annuities

The variable annuity differs from traditional fixed annuities because the risk of total loss of returns shifts to the purchaser. In contrast to the fixed annuity, variable annuities generally have no fixed rate of return, and the return is usually based upon the performance of an underlying portfolio of securities, or sub account.

While the purchaser has the chance for a substantial increase in the rate of return if the portfolio performs well, the purchaser also has no floor that acts as a "stop loss" on the rate of return if the portfolio performs poorly. With no element of fixed return, the insurer assumes no true investment risk with these products. Thus, these annuities lack the hallmark of insurance—

the underwriting of the investment risk by the insurer and some guarantee of fixed income benefits.

After variable annuities were introduced in the early 1950s, they soon caught the eye of securities regulators. The product was essentially a hybrid, with characteristics associated with both insurance and securities. Securities regulators believed that the variable annuity should fairly be deemed a security given its unlimited investment risk for the annuitant, and should not be exempt from federal securities regulation pursuant to Securities Act Section 3(a)(8).

In 1959, the U.S. Supreme Court agreed. In *S.E.C. v. Variable Annuity Life Insurance Company*, 359 U.S. 65 (1959), the Court decided that variable annuities, at their heart, were securities because they shift all investment risk to the purchaser of the annuity, with no real underwriting of risk by the issuer. The Court stated:

> In hard reality, the issuer of a variable annuity that has no element of a fixed return assumes no true risk in the insurance sense…. For in common understanding "insurance" involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts…. [The annuity issuers] guarantee nothing to the annuitant except an interest in a portfolio of common stocks or other equities…. There is no true underwriting of risks, the one earmark of insurance as it has commonly been conceived of in popular understanding and usage.

359 U.S. at 71–72.

In its discussion of the case, the Court acknowledged that the issuers of the policies assume the risk of mortality of the annuitant, should the annuitant live longer than expected, which "gives these variable annuities an aspect of insurance." The Court discounted this aspect of risk as "apparent, not real; superficial, not substantial," because it found that any such risk was very limited in nature because insurance companies carefully calculate mortality, and their mortality predictions are already reflected in the annuity contract. *Id.* at 70–71.

Once determined to be a security, variable annuities became subject to the registration and other requirements imposed by the federal securities laws. Because variable annuities are securities, those selling variable annuities are also required to obtain certain securities licenses and become FINRA members to sell variable annuities, the same as other securities broker-dealers and their registered representatives. This also means they are subject to FINRA's rules, including NASD suitability Rule 2310 which attaches to securities recommendations to customers, and suitability requirements imposed by state securities statutes.

Although the variable annuity was first conceived and used by the Teachers Insurance and Annuity Association in the early 1950s, it was not until 1960 that the first commercial variable annuity prospectus was available in the United States. Since that time, sales of variable annuities have exploded, as has the concern of securities regulators over sales practices used in connection with selling these products.

Variable annuity products often pay high commissions that can incentivize those selling variable annuities to push sales of these products harder than other financial products. In addition, annuity products can be more complex than many other types of investments, and baffle customers who do not have the financial savvy to fully understand these products—a combination ripe for sales practice abuses by those selling variable annuity products.

Amid growing concern about potential sales practice abuses in sales of variable annuities, the NASD issued NASD Notice to Members ("NTM") 96-86 (December 1996) to remind members and their associated persons that variable annuities are subject to NASD suitability requirements. NTM 96-86 also set forth suitability factors that members must consider in recommending a variable annuity to a prospective purchaser. In May 1999, the NASD issued a second reminder to members in NTM 99-35 (May 1999) concerning their responsibilities regarding sales of variable annuities. NTM 99-35 set forth guidelines for members to consider in making suitability determinations, and developing compliance and supervisory procedures for sales of variable annuities to customers, including tax-free exchanges under Internal Revenue Code §1035.

In 2007, FINRA codified many of the guidelines set forth in NTM 99-35 in NASD Rule 2821. Rule 2821 governs FINRA members' compliance and supervisory responsibilities in the initial purchase and exchange of deferred variable annuities, and initial subaccount allocations. This rule was developed to provide more protection to investors who buy or exchange deferred variable annuities, and to enhance broker-dealers' compliance and supervisory procedures for those products.

Rule 2821 was effective May 5, 2008, although a delaying amendment was filed by FINRA with the SEC in April 2008 to delay the effectiveness of paragraphs (c) governing principal review and approval, and paragraph (d) governing written supervisory procedures, which FINRA plans to substantively revise. Rule 2821 paragraphs (a) addressing the Rule's applicability and definitions, (b) regarding recommendations and suitability determinations, and (e) regarding training, are now in effect.

Reference to the rule should be made in transactions contemplated by Rule 2821 to fully understand the scope of responsibilities imposed. Generally, however, the paragraphs now in effect require that when registered representatives recommend a deferred annuity transaction, they must:

1) make a reasonable effort to obtain and consider various types of customer-specific information that bears on suitability of the product for the customer such as age, income, financial situation and needs, investment experience and objectives, intended use of the deferred variable annuity, investment time horizon, existing assets, liquidity needs, liquid net worth, risk tolerance and tax status;
2) have a reasonable basis to believe the customer has been told of all of the material features of the product, such as a surrender charge, potential tax penalty, various fees and costs, and market risk;
3) have a reasonable basis to believe that the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization or death or living benefits;
4) make a customer suitability determination as to the investment in the deferred variable annuity, the investments in the underlying sub-accounts at the time of purchase or exchange, and all riders and other product enhancements and features contained in the annuity contract; and

5) have a reasonable basis to believe that a deferred annuity exchange transaction is suitable for the particular customer, considering, among other factors, whether the customer would incur a surrender charge, be subject to a new surrender period, lose existing benefits, be subject to increased fees or charges, and has had another exchange within the preceding 36 months.

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In addition, Rule 2821(e) mandates that FINRA members develop and document training programs to ensure that registered representatives who effect variable annuity sales, and registered principals who review the transactions, comply with Rule 2821 and understand the product's material features. Although Rule 2821 relates to initial deferred variable annuity purchases, exchanges, and subaccount allocations, NASD Rule 2310 still applies to recommendations to sell a deferred variable annuity or to reallocate subaccounts.

Equity Indexed Annuities

Following commercial availability of the variable annuity, customers wanted new annuity products that would provide the benefits of increased stock market returns, with protective floors against market downturns. In response, the equity-indexed annuity (EIA) was created. Most equity-indexed annuities have long been categorized as fixed annuities and insurance products. Their returns are typically linked to a stock market index (usually the S&P 500 or the Dow Jones Industrial Average), but they also have a floor that guarantees some minimum return even in market downturns. This does not mean that you cannot lose money when buying an equity-indexed annuity, depending upon how the issuer computes the index-linked interest rate and any rate caps, fees, surrender charges, and tax penalties that may be imposed. Rather, it simply means that there is some "floor" that limits loss of the return portion.

There are some EIAs that are structured with a particular mix of features that make them a security, subject to SEC registration and SEC and FINRA regulation of those selling such products. Since EIAs were introduced to the market, however, there have been no clear standards for financial professionals to follow in determining when a particular EIA was a security or insurance product. In an effort to provide more clarity on the status of EIAs under the federal securities laws, on June 25, 2008 the SEC published proposed Rule 151A under the Securities Act for public comment. Proposed Rule 151A would prospectively establish standards for determining whether a particular EIA may be considered a security, or exempt form the Securities Act pursuant to Section 3(a)(8). Under proposed Rule 151A an EIA would be deemed a security, and not an exempt annuity contract or insurance policy under Section 3(a)(8), if the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

Proposed Rule 151A arose from the SEC's concern about abusive sales practices in the sale of EIAs, particularly to senior citizens for whom they may be unsuitable investments. Over the last decade, FINRA also has become increasingly concerned that EIAs are being misleadingly marketed and sold by associated persons of member firms. In response, FINRA published NTM 05-50 in August 2005. In NTM 05-50, FINRA does not take a position on whether a particular EIA is a security, but sends a warning signal to its members that they should closely scrutinize the EIAs sold by their associated persons to determine if they are a security. If so, they are subject to Rule 2310 and 2821. Suitability rules also apply when a recommendation is made to sell a security, including a variable annuity, to fund the purchase of an unregistered EIA.

Liability for Failure to Follow Applicable Suitability Rules

Liability lurks for those who make an incorrect determination as to the type of product they are recommending and/or selling, and its corresponding suitability rules. The consequences for violating the suitability rules in the sale of securities can be severe, depending on the egregiousness of the conduct. Pursuant to NASD Rule 8310, FINRA members can be subject to FINRA disciplinary proceedings, and among other things, incur fines, suspensions or a bar from association with any member firm, revocation of registration, and be ordered to pay restitution.

Where the conduct rises to the level of fraud, the SEC may seek similar sanctions including but not limited to, civil penalties, an injunction in a civil action or cease and desist in an administrative proceeding, suspensions or a bar from the industry and revocation of registration for regulated persons, and disgorgement of ill-gotten gains. In those states where an annuity product is classified as a security, similar sanctions may also be sought by state securities regulators.

With respect to civil litigation, liability for the sale of unsuitable life insurance policies or annuities can run the gamut of creative plaintiff counsels' imagination. In states where there are applicable insurance or securities suitability requirements (whether limited to seniors or not), there may be rescission, consequential and/or punitive damages, and plaintiff's attorney's fees and costs. In most of these cases, plaintiffs will also allege fraud which also could entitle them to punitive damages.

In states that have elder abuse statutes, plaintiffs also may try to allege that the sale of an unsuitable insurance policy or annuity was a form of elder abuse, opening the door to statutory consequential and punitive damages, as well attorney's fees and costs. In addition, depending on whether plaintiff can allege an institutionalized marketing of unsuitable insurance policies or annuities, there is also exposure to class action lawsuits.

Harmonizing Suitability Rules in the Insurance and Securities Industries

State insurance regulators formed the NAIC in 1871 to address the need to coordinate and harmonize regulation of multi-state insurers. The development of securities regulation to include variable insurance products created an additional asymme-

try with respect to suitability requirements for certain annuity products. Those selling annuities now have one set of standards for variable products, and EIAs and insurance policies deemed securities, and another seemingly lower standard for fixed products under state insurance statutes.

In June 2000, the NAIC adopted a white paper that specifically examined the issue of suitability standards in the context of unregistered life insurance and annuity products. The purpose of the study was to determine whether suitability standards should be adopted for all life insurance and annuity products. It was noted that the most significant difference between insurance and securities products is risk to principal. Insurance customers, however, have become more and more exposed to the risks of the equity markets with the development of universal policies (which offered the possibility of excess interest credits) and equity-indexed products (which offered the opportunity to participate in the insurer's return on equity investments).

At this point, the Suitability in Annuity Transactions Model Regulation 275 is the main formal NAIC document with suitability standards for insurance products. As previously noted, it has not been adopted by all states, and only adopted in modified form in others. For example, the Florida version, embodied in Fla. Stat. 627.4554, imposes suitability standards on sales of any fixed or variable annuity to "senior consumers," meaning anyone 65 years of age or older. In California, however, there are regulations applicable to variable life insurance (Reg. Tit. 10 §2534.2), life insurance and annuities (Ins. §789.8), and replacements of annuities to seniors 65 years of age and older (Ins. §§105093; 10509.8). In addition to Model Regulation 275, there is also the Variable Life Insurance Model Regulation 270, which includes provision Section 3 .C. establishing suitability requirements for every insurer selling variable life insurance.

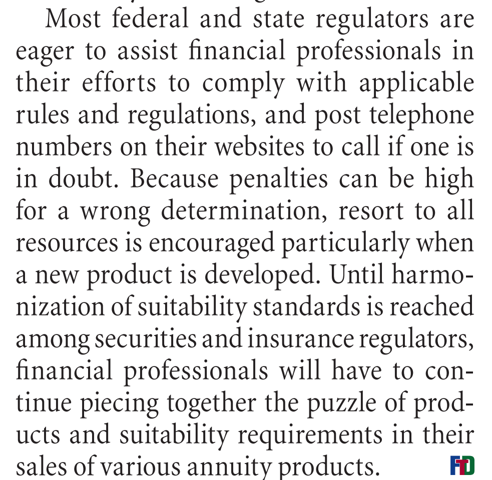
Because an artificial inequality began developing among the various products from a regulatory point of view, securities and insurance regulators have held "roundtables" in an attempt to harmonize suitability rules among their regulated products. While regulators acknowledge the problems with differing suitability requirements, and progress is being made, differing suitability rules still apply to insurance and securities products.

Evolving Custom Annuity Products—The Next Frontier

Undoubtedly the financial industry will continue to respond to customer demand, and we will continue to see even more customized annuity products designed to fit the particular retirement planning needs of customers. These products likely will contain a mix of principal guarantee, varying degrees of investment risk on returns, and death benefits.

Several forward thinking companies already have developed annuity contracts that allow customers to further customize their products by offering a "menu" from which customers can build their products. This way customers can get and pay for only the type of features desired in their annuity contract. It is easy to envision a future where annuity product returns may be linked not only to securities portfolios and indexes, but a variety of other domestic and international markets and indices with the permission of regulators.

These new products will necessarily require regulators, and the financial professionals that recommend these products, to take a fresh look at each new product to determine where the annuity falls within the various federal and state statutes and regulatory regimes. Determining what, if any, suitability rules apply is critical for ensuring compliance, and avoiding liability that can include severe penalties including an industry bar and significant fines.



Most federal and state regulators are eager to assist financial professionals in their efforts to comply with applicable rules and regulations, and post telephone numbers on their websites to call if one is in doubt. Because penalties can be high for a wrong determination, resort to all resources is encouraged particularly when a new product is developed. Until harmonization of suitability standards is reached among securities and insurance regulators, financial professionals will have to continue piecing together the puzzle of products and suitability requirements in their sales of various annuity products. FD