

New Model Regulation Gives Insurers Little to Be Thankful For

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On November 24, while everyone was recuperating from their Thanksgiving feast, the NAIC's Annuity Suitability Working Group circulated the Working Group Chair's draft of proposed revisions to the *Suitability in Annuity Transactions Model Regulation* (#275) (Suitability Model) to be renamed the *Suitability and Best Interest Standard of Conduct in Annuity Transactions Model Regulation* (Suitability and Best Interest Model). While the centerpiece of the proposed revisions is the best interest standard, the proposed draft sets forth a cornucopia of additional requirements. Notably, while the ACLI had begun to set the table for harmonizing the standard of care by proposing a Uniform Standard of Care framework, the proposed Suitability and Best Interest Model revisions add more courses than the industry is likely prepared to digest. In general, the proposed Suitability and Best Interest Model revisions:

- Broaden the scope and arguably require insurers to determine if an annuity "is reasonable prior to issuance," even if no recommendation is made unless the transaction is exempted under Section 4.
- Include consideration of "changes in nonguaranteed elements in an annuity contract" as part of the "suitability information" that must be considered in making an annuity purchase recommendation.

- Impose additional duties for recommended annuity transactions, including requiring that the recommendation be in the consumer's best interest.

The proposed Suitability and Best Interest Model revisions define "best interest" as "acting with reasonable diligence, care, skill and prudence in a manner that puts the interest of the consumer first and foremost." It also makes clear that best interest does not require a recommendation of "the least expensive annuity product, or the annuity product with the highest stated interest rate or income payout rate, available in the marketplace at the time of the annuity transaction ... or the single 'best' annuity product available in the marketplace at the time of the annuity transaction."

- Require additional disclosures to consumers in making the annuity purchase recommendation, including disclosure of cash compensation if it exceeds 3 percent, whether by commission or fee and disclosure of non-cash compensation if it exceeds \$100 per producer per year.
- Expand the required training to include financial exploitation of seniors and other vulnerable adults.

After digesting the proposed revisions, the various interpretive and practical issues are likely to give the industry heartburn. Some of these are discussed below. **Broadened Scope** The proposed revision modifies the scope of the Suitability Model and sets forth different standards depending on whether there is a recommendation.

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

Proposed Scope Language This regulation shall apply to any solicitation, negotiation, recommendation, or sale of an annuity.

For all annuity transactions other than those exempted under Section 4, if there is a recommendation, it must be suitable and in the consumer's best interest. For all annuity transactions other than those exempted under Section 4, if there is no recommendation, based on a plain reading of proposed Suitability and Best Interest Model Section 6.F., the insurer must determine the annuity *is reasonable* prior to the issuance based on the circumstances actually known to the insurer at the time the annuity is issued. Under the existing scope language, if there is no recommendation, arguably, the Suitability Model is not applicable and no standard, including the reasonable requirement, would be applicable. **Additional Suitability Information – Nonguaranteed Elements** The proposed Suitability and Best Interest Model revisions add additional suitability information that must be considered – changes in nonguaranteed elements in an annuity contract. No definition is included as to what constitutes a nonguaranteed element and no direction is given as to how to consider the nonguaranteed elements of an annuity contract. For example, does this mean the insurance producer must consider the value of the annuity contract to the consumer if the minimum or maximum guaranteed benefits, charges, fees, etc. apply? Given the number of variable components of an annuity contract, does the insurance producer simply assume that the worst

scenario would apply? How would this requirement apply in a replacement transaction? **Additional Duties** The centerpiece of the proposed Suitability and Best Interest Model revisions is the addition of the best interest requirement. It requires an insurance producer, or the insurer when no insurance producer is involved, to only make a recommendation "that is suitable *and in the best interest* of the consumer." In addition, an insurer must maintain procedures for the review of each recommendation designed "to ensure that there is a reasonable basis to determine that a recommendation is suitable *and in the best interest* of the consumer," as well for detection of "recommendations that are not suitable *and in the best interest* of the consumer." In addition, the proposed Suitability and Best Interest Model revisions state that the insurance producer, or the insurer when no insurance producer is involved:

- Shall receive no more than reasonable *cash compensation* in making a recommendation;
- Shall not make any materially misleading statements regarding the annuity transaction; and
- Shall not base a recommendation on the producer's or insurer's own financial interest.

The best interest standard and these three additional requirements fall in line with the Department of Labor's (DOL) impartial conduct requirements for fiduciary investment advice. The proposed Suitability and Best Interest Model revisions, however, also require that as part of making a recommendation, the insurance producer or insurer, as applicable, must evaluate "the types of financial products which correspond to the consumer's disclosed suitability information and address the consumer's financial objectives." This seems to suggest that before recommending an annuity product, the insurance producer or insurer must consider whether other types of financial products would be in the best interest of the consumer. The proposed Suitability and Best Interest Model, however, does not define financial products. To the extent that the term financial products includes securities, insurance licensed only producers would not have the requisite registration to consider whether a securities product would be in the consumer's best interest. **Additional Disclosures** Additional disclosure is added to the feast under the proposed Suitability and Best Interest Model revisions. The new disclosure that must be provided by the insurance producer, or the insurer when no insurance producer is involved, includes:

1. Any limitation on the insurance producer or insurer on the type of financial products that can be provided, including whether only specific insurer products or a limited range of annuity products can be offered;
2. The scope of services provided to the consumer by the insurance producer or insurer, as applicable;
3. The scope of the producer's license, as applicable;
4. The basis or bases of the recommendation;

5. Any and all material conflicts of interest;

6. Cash compensation received if it exceeds 3 percent, whether by commission or fee and non-cash compensation received if it exceeds \$100 per producer per year.

The first three items reflect that the producer's or insurer's, as applicable, offering to the consumer may be limited. Insurance only licensed producers may not offer securities products. In addition, due to the relationship between the licensed producer and insurer, only certain annuity products, or only annuity products of a specified insurer, may be offered to the consumer. This is consistent with the types of proprietary product disclosures required by the DOL's requirements for fiduciary investment advice. The fourth item, disclosure of the rationale of the recommendation, however, is not required by the DOL. This will require insurers to adopt procedures and policies for documenting the rationale for the recommendation that could be viewed as more than the collection of suitability information. While the fifth and sixth items are similar to the DOL's requirements, there are some differences. The DOL would require disclosure of all compensation, however, the proposed Suitability and Best Interest Model revisions appear to modify the material conflicts disclosure regarding compensation if it exceeds certain thresholds. The proposed Suitability and Best Interest Model revisions define material conflict of interest to mean "a financial interest of an insurance producer, or insurer where no producer is involved, that a reasonable person would expect to affect the impartiality of the recommendation." This definition would suggest that any and all compensation as to an annuity transaction should be disclosed. However, the proposed language in Section 6.C.(2) requires only disclosures of cash compensation that exceeds 3 percent of commissions or fees and Section 7 requires disclosure of non-cash compensation if it exceeds \$100 per producer per year. Also, the proposed language in Section 6.C.(2) would seem to allow no compensation disclosure of a yearly 2.99 percent advisory fee even though that fee over time would exceed a 3 percent up-front commission. In addition, as to the non-cash compensation, it is unclear how it would apply to independent producers who sell multiple insurers' products and receive incentives from a distribution partner. Does the \$100 limit apply to each insurer or all insurers and the marketing organization with which the producer is associated? If the latter, there would be no means by which any insurer could determine if the \$100 threshold is reached.

Expanded Training The proposed Suitability and Best Interest Model revisions add a new training topic – financial exploitation of seniors and other vulnerable adults. Currently under the Suitability Model, state required and approved training courses would satisfy the Suitability Model's training requirement. States, however, have not adopted training requirements with respect to financial exploitation of seniors and other vulnerable adults. Thus, current state required and approved training courses would not comply with the proposed Suitability and Best Interest Model revisions.

Additional Dinner Guest In harmonizing the Suitability and Best Interest Model, the proposed revisions include language changes adding FINRA requirements. The proposed Suitability and Best Interest Model revisions' FINRA safe harbor makes reference to FINRA requirements pertaining to best interest standards and supervision of annuity sales. It also states that a training course that complies with the requirements of FINRA Rule 1250 complies with the general annuity training requirements. FINRA does not currently have an explicit best interest requirement. Rather, FINRA's best interest standard

is addressed in FINRA Regulatory Notices, FAQs, FINRA comments on the DOL's fiduciary investment advice rule, speeches, and other interpretive material. **Additional Invitations** The NAIC's Annuity Suitability Working Group has invited regulators and interested parties to make initial, brief comments on the proposed Suitability and Best Interest Model revisions at the NAIC Fall National Meeting. The Working Group will set a public comment period and invite written comments for further consideration and discussion at future meetings, giving industry additional time to digest the changes. We will continue to monitor and report on the activities of the NAIC's Annuity Suitability Working Group.

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