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Suitability Working Group Stirs Ingredients for Suitability Model Potion

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On October 22 and 23, the NAIC Annuity Suitability (A) Working Group (Suitability WG) held an interim meeting to review comments received on the Suitability in Annuity Transactions Model Regulation (Model 275) (Suitability Model). Chair Dean Cameron stated the goal was to develop a draft revised Suitability Model that could be offered as a treat to the Life Insurance and Annuities (A) Committee (A Committee) at the NAIC Fall National Meeting in San Francisco. The draft revised Suitability Model would also allow the NAIC to join the party with the Securities and Exchange Commission and perhaps the Department of Labor as these federal agencies perform their wizardry on the standard of care rulemaking. On October 25, the NAIC Staff for the Suitability WG published a draft revised Suitability Model (October 25th Draft) incorporating the NAIC's notes of the revisions discussed below among others.

During the meeting, the Suitability WG members cast straw votes into the cauldron on the proposed language that would become part of the brew. Chair Cameron assured the Suitability WG and interested parties that the draft revised Suitability Model to be presented to the A Committee was not intended to be final, as the draft would boil up and appear again so all would have an opportunity to further comment. Indeed, in several instances, the Suitability WG opted not to bury certain proposals, but instead agreed to let them lurk in the shadows for further consideration in the future.

While there was vigorous debate on certain topics during the meeting, Chair Cameron and the Suitability WG called on the spirits of collaboration striving to find common ground for the draft revised Suitability Model. In fact, as some topics were debated and the potion continued to mix, proposed language or comments vanished.

Key considerations of the Suitability WG and interested parties included:

- Being flexible to take into account rulemaking by the SEC and DOL
- Existing legislation and rules, including the Dodd-Frank Act's reliance on the Suitability Model and harmonizing with SEC and FINRA rules
- Ensuring that the Suitability Model did not set up insurers, producers, and consumers for failure
- The impact of the Suitability Model on litigation
- Simplifying the language of the Suitability Model

The key topics debated during the meeting included:

- Duty owed and consideration of other products and the producer's interest
- Applicability to in-force transactions and definition of recommendation
- Consumer disclosures, including conflicts and basis for recommendation

Other topics discussed during the meeting but deferred included:

- Producers subject to the Suitability Model
- The exemption for certain contracts funding employee benefits
- Potential safe harbor or exemption for "Specified Fiduciaries"

Duty Owed and Consideration of Other Products and the Producer's Interest

Haunting the Suitability WG was the duty owed by producers under Section 6.A. of the Suitability Model and the operative terms used in Section 6.A. The discussions included:

- whether a recommendation must be "consistent with" or must be "in furtherance" of a consumer's objectives and needs;
- to what degree the producer must consider other products;
- whether the care standard should be a best interest standard; and
- whether the producer's interests can be considered.

> **Consistent With or In Furtherance**

For the definition of "suitable," Suitability WG members proposed language that requires a recommendation to be "in furtherance" of a consumer's needs while industry commentators

proposed or endorsed language that requires a recommendation to be "consistent with" a consumer's needs. One industry commentator questioned the meaning of "in furtherance." Chair Cameron queried whether there was any meaningful difference between the two phrases. James Regalbuto asserted that "in furtherance" is stronger. He gave an example of a consumer who needs a lifetime income product and noted a variable annuity with an income rider is consistent with that need, however, a single premium annuity may be in furtherance. This example suggests the regulatory view that under any particular circumstances there is a single product that better fits the consumer's needs. The October 25th Draft includes a definition of suitable that uses the "consistent with" language. If "in furtherance" is in the adopted revised Suitability Model, producers will need to carefully weigh the different products and recommend the product that "better fits the consumer's needs." It will also be interesting to see whether examiners will cast their own judgment over the producers as to the product that better fits the consumer's needs.

Consideration of Other Products

As part of the discussion on the definition of "suitable," the Suitability WG considered whether the recommendation should be based on the "annuities, insurance, investment and financial products the producer is authorized and licensed to recommend or sell." Regulators whose spell book does not include securities found inclusion of this language problematic as they would not have the subject matter expertise to consider non-insurance products when reviewing the suitability of a recommendation. One regulator suggested moving the phrase and requiring as part of a producer's process that all available products be considered rather than including the phrase in the definition of suitable. Hair raising to industry commentators was their supervisory responsibility with respect to other products available through the producer. Vice Chair Ommen stressed that to harmonize with other regulations, it is important that all products available through the producer must be considered. He also pointed out that insurers distributing through broker-dealers made that decision and pointed to the FINRA safeharbor under which insurers could contract with the broker-dealers to perform the supervisory responsibility over the registered representatives who may also sell securities products. Mr. Regalbuto pointed out that under New York Regulation 187, the insurer does not have the responsibility to know that the producer checked all products from the universe available through the producer. Mr. Regalbuto also asserted that from an enforcement standpoint, in determining the suitability of a recommendation, the regulator must look at the recommended product relative to the other products available through the producer. The Suitability WG initially agreed to a definition that does not include references to other products and that such references would be moved to other provisions. However, during the interim meeting, no decision was made as to where the reference to other products would be included, and the October 25th Draft did not incorporate such language.

Best Interest

While discussions on the best interest standard continued to lurk around throughout the meeting, the main discussion occurred in reviewing Section 6.A., which sets forth the recommending person's duties. Vice Chair Ommen articulated several reasons why a best interest standard should not be implemented – it is a foundation to a fiduciary standard, best interest has not been adequately defined making it hard to enforce, it increases litigation risk as producer compensation makes it difficult to prove the producer acted in the best interest, and a captive agent may not be able to satisfy the standard of care because the agent does not have access to a wide range of products. Several Suitability WG members and industry commentators questioned whether an objective best interest standard could be developed or whether it was necessarily a subjective standard, reflecting the difficulty of implementation and enforcement. In addition, concerns were raised that a best interest standard would not result in uniformity as different states would define or interpret the best interest standard differently. Ultimately, best interest language was not included.

> **Consideration of the Producer's Interest**

Perhaps the most debated issue during the interim meeting was how the producer's interest factored into a recommendation and the language in Section 6.A. Indeed, different proposals on Section 6.A. moved in and out of the shadows several times over the course of the interim meeting. While nearly all agreed the bones of Tennessee's proposed language was a good starting point, the Suitability WG and interested parties could not escape the devilish details in crafting language on the consideration of the producer's interest. The debate centered on whether:

> "only the consumer's interest shall be considered"
>
> "the consumer's interest shall be considered first and foremost"
>
> "the producer shall not place the producer's financial interest above the consumer's interest" or "ahead of the consumer's interest"

Many Suitability WG members and industry commentators were fearful that a producer would have difficulty demonstrating that "only the consumer's interest" was considered given the producer's receipt of compensation. Mr. Regalbuto offered a light in the dark suggesting that this could be solved by adding the following language from New York Regulation 187:

> The producer's receipt of compensation or other incentives permitted by the Insurance Law and the Insurance Regulations is permitted by this requirement provided that the amount of the compensation or the receipt of an incentive does not influence the recommendation.

Vice Chair Ommen noted that New York has a different regulatory scheme as it directly regulates compensation which may not be the case in other states such as Iowa in which compensation is regulated indirectly through the form filing process. Many questioned whether a producer would be haunted by the compensation to be received and would be unable to completely put it out of his or her mind or prove that compensation was not at all part of the consideration.

The regulators then considered language in which the consumer's interest is considered "first and foremost." Mr. Regalbuto and Birny Birnbaum of the Center for Economic Justice disagreed with any language that allows a producer's interest to be considered at all. The discussion centered around how to address the relative weight of the consideration, with one regulator questioning whether it is okay for a transaction to proceed if the consumer's interest was 51 percent and the producer's was 49 percent. Mr. Regalbuto reasserted that it is inappropriate for producers to consider themselves in making any recommendation.

The reappearing apparition rose again at the twilight of the interim meeting. Vice Chair Ommen stressed the need to harmonize with the SEC and proposed another version of Section 6.A.(1). In a relatively quick discussion, the Suitability WG agreed to use the "ahead of the consumer's interest" language. The October 25th Draft included the following:

> A. (1) A producer, or an insurer where no producer is involved, when making a recommendation of an annuity, shall ***act in the interest of the consumer*** at the time the recommendation is made, ***without placing the producer's or the insurer's financial interest ahead of*** the consumer's interest.

In-Force Transactions and Definition of Recommendation

Also bewitching the Suitability WG was the applicability of the Suitability Model to in-force transactions and the definition of recommendation.

The issue of in-force transactions was first summoned by Mr. Regalbuto during the review of the scope language when he reminded all that New York Regulation 187 applies to in-force transactions. Mr. Regalbuto suggested language broadening the scope of the Suitability Model. Keith Nyland explained that New Hampshire's suitability requirements apply to new purchases of an existing contract.

The issue was again conjured up in the review of the term "recommendation." Different regulators questioned whether recommendations regarding in-force policy transactions should be subject to the Suitability Model requirements. Mr. Nyland urged that, if a consumer seeks a producer's recommendation on whether to add money to an existing annuity or use it for other purposes, then that recommendation must be subject to the Suitability Model. Rhode Island and New York agreed.

In trying to calm the bubbling cauldron, Chair Cameron recognized that requiring updated client information was appropriate, but worried that the Suitability WG may be opening Pandora's box and cautioned care in proceeding. Industry commentators understood the concerns raised by regulators but also cautioned that regulators were entering murky waters and needed to consider how the different requirements would apply to the array of post-issuance transactions. Vice Chair Ommen queried what additional protections would be gained and at what costs to insurers who would have to develop and implement additional policies and procedures. Given the potential quagmire, the motion to include in-force policy transactions was withdrawn. That being said, the issue of in-force transactions is likely to have an afterlife, returning to haunt future discussions.

Once the discussions on in-force transactions died, the Suitability WG considered other changes to the definition of "recommendation," including the addition of:

- "individualized" in front of advice
- "reasonably interpreted by the consumer to be advice"
- "suggestion"
- "financial transaction" in front of purchase, exchange or replacement"
- "communication that would be viewed by a reasonable consumer to be advice"

After the various motions, substitute motions, and a roll-call vote, in the end, only the term "individualized" was added.

Consumer Disclosures of Conflicts and Basis for Recommendation

In looking at what tricks and treats producers must disclose to a consumer, the Suitability WG considered:

- the definition of material conflict of interest
- what non-cash compensation should be disclosed
- disclosure of the basis for the recommendation

Initially, the Suitability WG addressed the definition of material conflicts of interest. Some questioned whether a definition is needed given that there is required disclosure of the cash and non-cash compensation received by the producer. Mr. Birnbaum urged that there may be some conflicts that are too scary and the transaction should not permitted even in the face of disclosure. Industry commentators noted that conflicts should be addressed by disclosure and that trying to define prohibited conflicts is subjective. Mr. Regalbuto acknowledged that material conflict of

interest was too hard to define, and was excluded from New York Regulation 187. Instead, as long as the consumer is first, compensation is okay. The Suitability WG agreed a material conflict of interest exists when there is a financial interest “a reasonable person would expect to influence the impartiality” of the producer.

In reviewing the disclosure requirements contained in Section 6.C., the Suitability WG discussed what kind and what amount of non-cash compensation must be disclosed. Given the variety of non-cash compensation, some were concerned about being too prescriptive or that the extent of the necessary disclosure would scare customers away. In addition, questions arose as to how to deal with contests. A producer may not know about his or her eligibility for a contest at the time of a particular transaction. Jodi Lerner suggested that all contests based on a target were suspect. Mr. Birnbaum raised that the disclosure should be relative – if product A is recommended, compensation is $X and if product B is recommended compensation is $2X. Given the thick fog, the Suitability WG agreed to defer this issue.

The Suitability WG also discussed what disclosures should be made as to the basis for the producer’s recommendation. Vice Chair Ommen noted that, after discussions with producers, Iowa suggests that the basis could be disclosed orally to the consumer as part of the organic sales process. Mr. Regalbuto stressed that there needed to be a document that codifies the understanding between the consumer and producer as to why a particular product was selected. The Suitability WG proceeded with Iowa’s proposal.

Producers Subject to the Suitability Model

Based on New York Regulation 187, Mr. Regalbuto proposed language that would make all producers who were materially involved in a transaction subject to the Suitability Model. He explained that an inexperienced producer may rely on a manager to facilitate a transaction or an agency may have an investment specialist whose advice is relied upon. Mr. Regalbuto acknowledged some spells were needed for the Regulation 187 language and agreed to get out his magic wand to recast the language to fit within the Suitability Model.

Exemption for Certain Contracts Funding Employee Benefits

Ms. Lerner raised alarms about sales where employees can select among different annuity and retirement products in which the employees may receive recommendations. The Suitability WG discussed that there are employee benefit arrangements in which ERISA is not applicable and there would not be an ERISA fiduciary who would look after the employees. The Suitability WG agreed to potentially revisit this exemption.

Safeharbor or Exemption for “Specified Fiduciaries”

AXA and Jackson National Life Insurance Company proposed an exemption or safeharbor for individuals who satisfy the definition of "specified fiduciary." The Suitability WG agreed to table consideration of the proposal opting to wait for the SEC's rulemaking on duty of care with the goal of harmonizing.

We will attend the NAIC Fall National Meeting to continue monitoring the activities of the Suitability WG, and will continue to monitor other standard of conduct initiatives.

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