CARLTON FIELDS

Annuity Suitability Working Group Tries to Get Out of the Parking Lot

August 07, 2019

The NAIC Annuity Suitability Working Group (Suitability WG) spent the summer at the July 23, July 29, and August 3 Suitability WG meetings trying to get out of the parking lot and discussed several issues to frame up the proposed revisions to the Suitability in Annuity Transactions Model Regulation (Suitability Model). Chair Jillian Froment explained that the Suitability WG is trying to develop a best interest standard that is less than a fiduciary standard but greater than the current suitability standard. She then directed the Suitability WG through the "parking lot" issues to reach general consensus on a framework for the proposed revisions.

1. Material Conflict of Interest

Chair Froment sought to separate into different lanes conflicts that really cause some concerns and those that are more extraordinary situations, recognizing that different means to mitigate would apply to the different types of conflicts.

- Sales Compensation

The Suitability WG members zigged and zagged as they discussed the different ways in which a producer could receive compensation for the sale of annuity products. While some suggested that fee-based or trail-based compensation structures create less conflicts, most agreed that the Suitability WG should not favor any compensation structure. Some members did not want commissions to automatically be considered a material conflict of interest.

- Incentives and Non-Cash Compensation

The Suitability WG circled the lot on how to address incentive compensation and non-cash compensation. Some members noted that producers may not be aware of whether they qualify for an incentive compensation at the time of a sale. Others questioned whether the different types of incentive and non-cash compensation should be treated the same. Some members pointed out that the SEC's Regulation Best Interest prohibits certain incentives. Most agreed that incentives based on sales of a particular product are problematic. Chair Froment stopped the Suitability WG's circling on this issue and posited that further discussion would be needed on the different types of incentives and non-cash compensation.

- Ownership Interest

The Suitability WG agreed that if a producer has an ownership interest in the insurer whose products the producer is recommending, a material conflict exists. All noted that this would be an unusual circumstance.

2. Managing Conflicts of Interests

In discussing the different types of conflicts, the Suitability WG also discussed how the conflicts could be managed. The Suitability WG debated the extent to which disclosure could mitigate certain conflicts and how much disclosure should be given to the consumer. Some members contended that meaningful disclosure is tough to do well. Birny Birnbaum questioned whether compensation disclosures would be comprehended by consumers.

The Suitability WG also discussed who should be charged with managing conflicts — the producers or the insurers. Several members pointed out that producers do not control the amount of sales compensation they receive and may not be aware of whether they qualify for any particular incentive compensation. Because of this, some members pondered whether insurers should be required to have policies or procedures that manage the conflicts of interest. Birnbaum suggested that insurers or their distribution partners should design and deploy compensation packages that "do not undermine a best interest standard of care." Some Suitability WG members wondered how an insurer with an independent sales force could supervise incentives. With respect to non-sales based incentives, an insurer would likely not know the incentives its various independent producers could earn through other insurers.

3. Inclusion of Prudence

Many states, including Iowa, Nebraska, Tennessee, and Illinois, do not think the Suitability Model's care obligation should include the term "prudence." They honked that the concept of prudence is tied to the prudent investor rule and other established legal concepts and existing case law, which will govern the term's interpretation if included in the Suitability Model. They also raised concern that

acting with prudence could be interpreted as acting with caution and the goal of preserving assets, which, depending on a consumer's risk tolerance, may not be the best course of action to meet the consumer's financial needs and goals. Birnbaum beeped back that only by including prudence does the care obligation focus on consumer outcomes, because the remaining terms — diligence, care, and skill — are all producer-focused. Birnbaum's continued focus on consumer outcomes suggests there would be a rearview mirror determination of whether the consumer's annuity purchase actually achieved the consumer's financial and other objectives and met the consumer's needs. In urging that the Suitability WG keep prudence, he agreed to provide a proposed definition for consideration. Chair Froment halted the discussion and posed the following questions:

- How does the current language "best suited to the customer in light of the consumer's profile information" fail to achieve the desired standard of care for consumers?
- Does adding prudence fill a gap so that regulators can take action against bad actors?
- If prudence is not defined, does that create an ambiguity that will be interpreted according to case law?

4. Inclusion of "Ordinary Producer" as a Measure of the Standard

The Suitability WG agreed that the "Ordinary Producer" standard is not appropriate because it is not in line with the goal of creating an enhanced standard and would be unworkable to enforce.

5. Disclosure of the Basis for Recommendation to Consumers

The Suitability WG hit a traffic jam when it considered whether the basis for a recommendation should be provided in writing to consumers. California, Maine, and Illinois argued that consumers should be given the basis for a recommendation in writing, or both orally and in writing. They noted that producers are already required to document the basis for a recommendation in their files. Giving consumers the basis for a recommendation in writing would ensure that the producer and consumer are on the same page and would protect producers from consumers coming back later to complain. Iowa, Idaho, and Tennessee contended that because of the many different dynamics of the sales situation, including the possibility that conversations between a producer and consumer are happening over a span of time, the producer should be able to provide the basis of the recommendation to the consumer only orally. Some also noted that companies, in satisfying a written requirement, may implement long generic documents that do not provide additional consumer protection. Or worse yet, producers will avoid making recommendations to avoid the legal requirement.

6. Care and Reasonable Basis

Chair Froment did a U-turn in asking the Suitability WG to review the existing language in the Suitability Model to help develop the care obligation. Chair Froment questioned whether the care obligation should incorporate a duty to have:

- A reasonable basis to believe the consumer would benefit from certain features of the annuity; and
- A reasonable basis to believe the particular annuity as a whole would address the consumer's needs.

No regulator objected. Birnbaum, however, attempted to slam the breaks by asserting that the care standard should incorporate a higher duty to ensure consumer outcomes. While some members suggested some wording changes to the reasonable basis language, Chair Froment waived the language through and noted that wordsmithing would be done with the next steps.

7. Failure to Obtain the Consumer's Profile Information

The Suitability WG discussed whether an annuity transaction should be permitted if a producer fails to obtain the consumer's profile information. Birnbaum asserted that no transaction should be permitted. Suitability WG members understood that a consumer should have the right to refuse to provide his or her information and still purchase an annuity. In such case, the members posited that the consumer should be informed of the consequences of the refusal — without the information the producer may not make a recommendation. The members also discussed the need for supervision by insurers to protect against producers encouraging consumers to refuse to provide information as a means of circumventing the Suitability Model requirements. Some members suggested insurers should track by producer those sales in which the consumer failed to provide his or her profile information and review those producers whose sales may suggest a practice of encouraging consumers to refuse to provide information.

8. Duty to Supervise Only Extends to Own Products

The Suitability WG members generally understood that insurers can only supervise the sales of their own products. However, California and Birnbaum asserted that an insurer must have some awareness of other products. California stated that in assessing a replacement, the insurer must have knowledge about the product being replaced. Birnbaum cautioned that insurers should be aware of other products in the event those other products may be better suited for the customer. While an insurer may receive a consumer's profile information, the insurer's knowledge about the consumer is limited. Thus, no insurer would have the type of relationship with a consumer to know whether another product would be best suited for the customer. Thus, even if insurers had knowledge about other insurers' products, no insurer could satisfy Birnbaum's proposed requirements.

9. Next Steps

Chair Froment is moving the Suitability WG out of the parking lot and is forming a technical drafting group that will revise the current Suitability Model based on the framework developed by the Suitability WG over the summer. Chair Froment seeks to expose the draft revisions in mid-September and then will hold weekly meetings with the hopes of reaching the finish line by the Fall National Meeting.

Authored By

Ann Young Black

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