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Life Insurance and Annuity Developments

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Recent life insurance and annuity developments include:

- Securities and Exchange Commission (SEC) enforcement action involving an unapproved variable annuity exchange program in violation of Section 11 of the Investment Company Act of 1940 (1940 Act);
- Financial Industry Regulatory Authority (FINRA) investor guidance on variable annuity exchanges; and
- Suitability Working Group of the National Association of Insurance Commissioners (NAIC) Life Insurance and Annuity (A) Committee (A Committee) frequently asked questions (FAQs) addressing the expanded safe harbor in the NAIC's 2020 revised *Suitability in Annuity Transactions Model Regulation* (#275) (Suitability Model).

Variable Annuity Exchange Offer Enforcement Action

On May 25, 2022, the SEC announced a settled enforcement action against a principal underwriter of variable annuity contracts alleging an unlawful variable annuity exchange program and noting that the case was the "first-ever enforcement proceeding" under Section 11 of the 1940 Act. [Investment Company Act Release No. 34592.]

Section 11 makes it unlawful for any registered open-end investment company or unit investment trust, or any principal underwriter for such company, to make an offer of exchange for a security "in the same or another such company" on any basis other than relative net asset values of the respective securities to be exchanged unless the terms of the offer have been approved by the SEC or the offer complies with exemptive rules under Section 11.

Rule 11a-2 under the 1940 Act permits variable annuity exchange offers without SEC approval if conditions are satisfied. When both the old contract and new contract are subject to a deferred sales charge: (1) no surrender charge is deducted at the time of the exchange; and (2) when computing the surrender charge for the new contract, the insurer credits the period during which the contract owner held the old contract (known as tacking).

As expressed in an SEC Staff no-action letter issued to *Alexander Hamilton Funds* (July 20, 1994), the SEC Staff takes the position that Section 11 applies to exchange offers involving affiliated investment companies but not to all exchange offers involving unaffiliated investment companies.

The SEC order alleged that wholesalers for the principal underwriter developed "lists of in-force annuities for the purpose of identifying potential variable annuity exchange opportunities." The lists allegedly were used to encourage registered representatives to offer variable annuity exchanges

to customers. The variable annuity exchanges did not involve tacking. The number of exchanges increased while the exchange offer program was in place.

When the principal underwriter's compliance department became aware of the unapproved exchange offers, it conducted an internal investigation and issued letters of reprimand/caution to wholesalers involved in the exchange program and supervisors who supervised individuals involved in the exchange program. The compliance department ended the exchange program and instituted a training program that included how an unapproved exchange program violates "principles of Section 11."

The SEC's cease and desist order censured the principal underwriter and imposed a $5 million civil money penalty. Without admitting or denying the findings, the principal underwriter consented to the order.

The case illustrates that unless internal variable annuity "exchange programs" are approved by the SEC, they must comply with Rule 11a-2. It also illustrates the importance of robust training on the requirements of Section 11. The lists of variable annuity contract owners created by the principal underwriter's wholesalers, and the related plan for approaching contract owners to offer an exchange, if compliant with Rule 11a-2 or if approved by the SEC, would not have raised issues under Section 11.

FINRA Investor Guidance on Variable Annuity Exchanges

FINRA discussed variable annuity exchanges in its *2022 Report on Examination and Risk Monitoring Program.* FINRA noted that broker-dealers had not reasonably supervised exchanges for compliance with FINRA Rule 2330 and Regulation Best Interest. It identified exchanges that were inconsistent with the customer's objectives and time horizon and resulted in increased fees to the customer or the loss of material, paid-for accrued benefits.

In May 2022, FINRA issued investor guidance entitled "*Should You Exchange Your Variable Annuity Contract*?" FINRA's guidance discusses good and bad reasons for exchanging one variable annuity for another. Reasons to exchange could include investment options under the new contract that are better suited to the contract owner's investment goals and objectives. Reasons not to exchange could include:

1. when the new contract offers a bonus or credit (because variable annuities with bonus credits may have higher expenses that offset any gain);
2. when a contract owner thinks he or she may need money in the short term (due to the impact of surrender charges); and
3. when a contract owner would pay higher fees and charges under the new contract or pay for contract features that are not needed.

NAIC Suitability Model "Comparable Standards" Safe Harbor FAQs

The 2020 revisions to the Suitability Model include a best interest standard of conduct for insurers and producers, an expanded "comparable standards" safe harbor, and revised training requirements. As previously reported, in 2021 the NAIC Executive (EX) Committee approved an FAQ guidance document regarding 2020 revisions to the 2010 Suitability Model. Now, the NAIC Suitability Working Group is working on FAQs relating to the comparable standards safe harbor.

As background, the 2010 Suitability Model safe harbor—commonly referred to as the FINRA safe harbor—provided that sales of variable or fixed annuities made in compliance with FINRA requirements would satisfy the requirements of the 2010 Suitability Model (except for a separate training requirement). The 2020 Suitability Model expanded the FINRA safe harbor to apply to recommendations and sales of variable and fixed annuities made by financial professionals in

compliance with comparable standards. For example, recommendations and sales made in compliance with SEC Regulation Best Interest or the fiduciary standard under the Investment Advisers Act would presumably satisfy the requirements of the 2020 Suitability Model.

In May 2022, the NAIC Suitability Working Group released 11 questions relating to the comparable standards safe harbor and requested comments. A group of several trade associations have collaborated on proposed answers to the FAQs that the Suitability Working Group will consider adopting. Some of the FAQs include:

- When would a producer be considered to be acting as a financial professional for purposes of the safe harbor provision?
- What comparable standards meet the criteria for the safe harbor?
- If a financial professional makes a recommendation or sale of an annuity in full compliance with a comparable standard, does the financial professional also have to satisfy all of the specific requirements of the revised model?
- Are insurers required to conduct regular audits, or otherwise verify, that the financial professional or entity supervising the financial professional is complying with the comparable standard?

As of July 8, 2022, 27 jurisdictions have adopted the 2020 revisions to the Suitability Model, and proposals in six more jurisdictions are pending state action.

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