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Life Insurance and Annuity Developments

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Recent life insurance and annuity developments include (1) Financial Industry Regulatory Authority (FINRA) focus on variable annuity exchanges and buyout offers; (2) National Association of Insurance Commissioners (NAIC) lowering the floor on the minimum standard nonforfeiture rate for individual deferred annuity contracts; and (3) congressional bills requiring the Securities and Exchange Commission (SEC) to adopt a new form for registration of registered index-linked annuity contracts (RILAs).

FINRA Focus on Variable Annuity Exchanges and Buyout Offers

In an effort to beef up broker-dealer compliance programs, the *2021 Report on FINRA's Examination and Risk Monitoring Program*, issued on February 1, 2021 (Report), provides insights on variable annuity sales practices. As relevant to firms distributing and selling variable annuities, the Report summarizes examination findings on unsuitable exchanges, buyout offers, inadequate source of funds review, and insufficient training. The Report also identifies effective practices relating to the examination findings.

In particular, FINRA found the following: (1) unsuitable exchanges, (2) written supervisory procedures (WSPs) not addressing supervision of buyout offers, (3) inadequate review of source of funds, and

(4) insufficient training of registered representatives and supervisors on how to assess fees and charges and whether an exchange would be suitable for a customer.

Exchanges

Following recent enforcement actions alleging unsuitable variable annuity exchanges and failure to supervise recommendations of variable annuity exchanges, FINRA asks firms in the Report to consider whether associated persons are effecting variable annuity exchanges “at a rate that might suggest conduct inconsistent with [FINRA] Rule 2330.” In particular, the Report asks firms to consider: (1) how the firm reviews and monitors rates of variable annuity exchanges (that is, automated tools, exception reports, or surveillance reports); and (2) whether the firm has standardized review thresholds for rates of variable annuity exchanges.

The Report notes the following effective variable annuity exchange practices:

- “requiring registered representatives to provide detailed written rationales for variable annuity exchanges for each customer (including confirming that such rationales address the specific circumstances for each customer and do not replicate rationales provided for other customers); and

- requiring supervisory principals to verify the information provided by registered representatives, including product fees, costs, rider benefits and existing product values.”

Buyout Offers

In 2020, FINRA conducted an informal review of variable annuity buyout offer WSPs, training, and disclosures. The Report asks firms to consider the firm’s process to supervise buyout offers (that is, whether the process includes pre-approval, exception reports, and post-transaction reviews).

The Report addresses procedures for when a firm stops selling a particular variable annuity product or opens buyout or exchange periods. For example, the Report asks: “Does your firm have WSPs to address when it decides to stop selling or retires certain products, or opens buyout or exchange periods, including, but not limited to:

- how it will handle the product termination process;
- how it decides whether it offers an exchange or buyout;
- the scope of its exposure (in terms of contracts and customers);
- how it will notify customers and registered representatives; and
- how it will monitor for exchange rates?”

The Report outlines effective practices regarding variable annuity buyout offers, including:

- “performing a holistic review of buyout offers;
- requiring supervisory principal pre-approval (and, in some cases, additional second-level approval) for buyout offers; and
- requiring registered representatives’ recommendations to consider all changes to customers’ variable annuities, such as possible

surrender charges, loss of benefits, contract values, riders, cash surrender values, expenses and fees.”

The Report asks firms to consider how the firm has implemented Reg BI when a registered representative recommends a purchase or exchange of a variable annuity. For example, the Report asks:

- “what do your WSPs require registered representatives to do in order to support a determination that a transaction meets the standard of care requirements and that there is a reasonable basis for it?
- what is the manner in which registered representatives are to obtain, evaluate and record such information such as whether a customer:
 - would incur a surrender charge;
 - would be subject to a new surrender period;
 - would lose existing benefits;
 - would be subject to increased fees or charges;
 - would invest a substantial portion of the customer’s liquid net worth in the variable annuity;
 - has liquidity needs that are inconsistent with the variable annuity;
 - would be investing in a share class that is not in the customer’s best interest given his or her financial needs, time horizon and riders included with the contract; and
 - has had another exchange within the preceding 36 months?”

The Report provides a roadmap for firms to review and revise their WSPs and training programs, with an emphasis on addressing and mitigating conflicts of interests, automated surveillance, thresholds for exchanges, and data integrity, among others.

NAIC Lowers Standard Nonforfeiture Rate for Deferred Annuities

The protracted low interest rate environment has caused ripple effects throughout the insurance industry. For issuers of fixed annuity contracts, the one percent floor on the minimum nonforfeiture rate has been one of the issues causing concern. The issue also has consumed insurance regulators' attention.

At the NAIC national meeting in December 2020, the Executive (EX) Committee and Plenary adopted revisions to the *Standard Nonforfeiture Law for Individual Deferred Annuities* (model 805). Model 805 applies to non-variable annuity products. The revisions lower the minimum nonforfeiture rate from one percent to 0.15 percent for new business. Insurance industry trade groups, including the American Council of Life Insurers and the Insured Retirement Institute, supported lowering the minimum nonforfeiture interest rate floor from one percent to zero percent to "give companies more flexibility to provide the value and benefits wanted and needed by consumers."

Implementation of the new minimum nonforfeiture rate has been delayed pending work of the Interstate Insurance Product Regulation Commission (IIPRC) on how to incorporate it into IIPRC Uniform Standards. In late March, the IIPRC determined that the 0.15 percent rate could become effective immediately upon a state's amendment of its nonforfeiture laws consistent with Model 805.

Registration of RILAs

SEC registration of RILAs has been described as the proverbial square peg/round hole problem. RILAs credit interest based on performance of an index, and offer upside interest crediting features (cap rates, participation rates, performance triggers) with downside protection features (buffers, protection rates).

The SEC does not have a dedicated registration form for RILAs, so insurers register the product on Form S-1 (or sometimes S-3). Form N-4 for variable annuities is not available because RILAs do not involve an investment company.

Registration of RILAs on Form S-1 requires disclosure of information that is irrelevant to a purchaser, in part because there is no secondary market for RILAs and RILAs do not involve the purchase of an equity interest in the insurance company. To address this problem, Congress introduced two companion bills in 2020 that would direct the SEC to establish a new form for the registration of RILAs: (1) Senator Tina Smith (D-MN) introduced S.3795, Registration for Index Linked Annuities Act of 2020, and (2) Representative Dean Phillips (D-MN) introduced H.R. 6994, the Registration for Index-Linked Annuities Act.

The bills provided that, if the SEC does not adopt a new registration form for RILAs within one year from enactment of the Act, insurers may register RILAs on Form N-4. Both bills died in committee at the end of the 116th Congress. Given the popularity of RILAs, the 117th Congress may well reintroduce the RILA registration form bills.

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