

In the Duty of Care Race, the NAIC Is in the Chase with New Proposed Revisions to Its Annuity Suitability Model

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On July 24, in preparation for its August 4 meeting at the NAIC 2018 Summer National Meeting, the Annuity Suitability (A) Working Group (the “Suitability WG”) peddled fast and released a working draft of proposed revisions (the “Summer Meeting Suitability Draft”) to the *Suitability in Annuity Transactions Model Regulation (#275)* (the “Suitability Model”). Of note, the Summer Meeting Suitability Draft:

- does not incorporate a best interest standard of care but instead incorporates a requirement to act “with reasonable diligence, care, skill, and prudence”;
- stays on the marked trail and does not extend the Suitability Model to life insurance or in-force transactions; and
- reflects the Suitability WG’s intent to discuss industry proposed language that nothing in the Suitability Model would “[c]ause any producer or insurer to be treated as a fiduciary, or impose a duty of loyalty on any producer or insurer, under common law or any federal or state law or regulation.”

The Summer Meeting Suitability Draft includes:

- proposed changes to the Suitability Model based on the discussions at the Suitability WG’s May 31 and June 1 in-person meeting; and
- specific comments and suggestions on sections of the Suitability Model for further discussion at the Summer National Meeting.

The significant proposed changes, comments, and suggestions for discussion at the Summer National Meeting are set forth below.

Requirements in Connection with Making a Recommendation

Proposed Revisions

Persons who make a recommendation – i.e., the producer or insurer where no producer is involved (the “Recommender”) – to a consumer will have to switch to a higher gear as the Summer Meeting Suitability Draft revises Section 6 of the Suitability Model to set forth additional requirements on Recommenders. In particular, a Recommender must:

- **not** place the Recommender’s **financial interest** above the consumer’s interest when making a recommendation of an annuity product;
- act with reasonable diligence, care, skill, and prudence;
- make suitable recommendations by **considering the types of products that may align with the consumer’s** disclosed suitability information and address the consumer’s financial situation, objectives, and needs. In making the recommendations, the Recommender is only required to consider the products that the Recommender sells, avoiding a potential uphill climb.

The above consideration supplements the Suitability Model's existing requirement that the Recommender obtain the consumer's suitability information and have a reasonable basis to believe that the consumer would benefit from certain features of the annuity as a whole, including riders and other product enhancements;

- with respect to a **replacement transaction**, have a reasonable basis for believing that the replacing product will provide a **substantial benefit** to the consumer in comparison to the replaced product over the life of the product and that the consumer has not made another replacement in the preceding 60 months. Thus, the Summer Meeting Suitability Draft extends the replacement period to be considered from 36 to 60 months;
- make the following **disclosures to the consumer**:
 - the role of the Recommender and the Recommender's **relationship to the consumer**;
 - the types of and **limitations on** the products that **the Recommender** sells;
 - if the Recommender is a producer, the manner and **amount of compensation** to be received by the consumer for the sale or the recommended annuity, including non-cash compensation that exceeds \$500 per year. The compensation may be received from an insurer or from an intermediary;
 - all **material conflicts of interest**; and
 - the basis or **bases for the recommendation**.

In addition, the Summer Meeting Suitability Draft, supplements the required disclosures on the various features of the recommended annuity to include disclosures of the potential changes in the non-guaranteed elements of the annuity.

Additional Summer National Meeting Discussion Items

Parts of the trail are still unmarked as a number of suggestions with respect to a Recommender's requirements will be discussed at the Summer National Meeting, including:

- What constitutes non-cash compensation?

The revisions to the Summer Meeting Suitability Draft include proposed definitions of "Non-cash compensation." The proposed definitions submitted by the California Department of Insurance (CDI) and the Iowa Insurance Division (IID) signal a fork in the course, as they differ vastly in scope. The CDI's proposed definition is broad and includes "any form of compensation that is not cash compensation." The IID takes a narrower trail and limits its definition to non-cash compensation received "from an insurer or intermediary" that is "variable or dependent on the volume of annuity sales production." Both definitions give similar but different examples of non-cash compensation, with the IID's version including "marketing or advertising expenses."

Providing a map of what constitutes non-cash compensation, or for that matter, what constitutes interests or incentives that must be disclosed to consumers, would enable all cyclists to finish the race safely.

- What constitutes a suitable recommendation?

The revisions to the Summer Meeting Suitability Draft include proposed definitions of "Suitable." The proposed definitions from the ACLI, the IID, and the New York Department of Financial Services (NY DFS) speak in terms of "consistent with the consumer's insurance needs and financial objectives," or "in furtherance of a consumer's objectives and needs."

The Summer Meeting Suitability Draft, currently requires a Recommender, after obtaining the consumer's suitability information, to (i) make recommendations that align with the consumer's disclosed suitability information and address the consumer's financial situation, objectives, and needs, and (ii) have a reasonable basis to believe that the consumer would benefit from certain features of the annuity as a whole, including riders and other product enhancements. Given the existing language, the proposed suitability definition may not be needed to provide additional clarity to consumers, producers, or insurers as to what constitutes a suitable recommendation.

- What constitutes a material conflict of interest?

The CDI, IID, and the Center of Economic Justice (CEJ) together with the Consumer Federation of America (CFA) provided proposed definitions for material conflict of interest. In general, under the proposed definitions, there must be an incentive to the Recommender for making the recommendation. The different proposals speak in terms of "financial interest," "financial incentives or rewards," or "financial or other interest." The CDI and IID's definitions add examples of

types of incentives, as follows:

CDI Proposal :

direct interest or ownership in an insurer by an insurance producer or an immediate family member of an insurance producer and . . . non-cash compensation available to, offered to or received by a producer or intermediary as a result of meeting target sales levels.

IID Proposal :

financial incentives or rewards offered to or received by the producer, or a direct interest or ownership in an insurer by the producer or an immediate family member of the producer.

The following proposed material conflict of interest definitions reflect that these incentives impact a Recommender's judgement.

CDI Proposal :

a reasonable person would expect [the financial interest] **to effect the ability** of the producer and/or insurer to: (a) **exercise his/hers/its best judgment**, and (2) **put the consumer's interests before** the producer's and/or insurer's own interest.

CEJ and CFA Proposal :

a reasonable person would expect [the financial interest] **could affect** the **impartiality of the recommendation** or the ability of the insurer or producer **to act in the consumer's best interest**.

IID Proposal :

a reasonable person would expect [the financial interest] **to influence a recommendation** of the producer or insurer . . .

If a material conflict of interest exists under the CDI's or the CEJ and CFA's proposed definitions, would a Recommender already be flipping over the handle bars? The proposed definitions could be viewed as creating a presumption that the Recommender could not satisfy the Summer Meeting Suitability Draft's requirement that a Recommender must not place the Recommender's financial interest above the consumer's interest when making a recommendation of an annuity product. Thus, it would seem that if either proposal's language is adopted, the language should be recast as precluding a recommendation for those circumstances where the Recommender's interests are so significant they cast doubt on the Recommender's objectivity.

Moreover, instead of using loaded terminology like "material conflict of interest" should the Suitability Model instead require that a Recommender disclose its interest in the recommended annuity purchase? That would allow the consumer to weigh the disclosed basis or bases for the recommendation against the Recommender's disclosed interest in the transaction so the consumer could determine whether to continue with the annuity purchase.

- How should the Recommender's financial Interests be considered?

The Tennessee Department of Commerce and Insurance (TN DOCI) suggested another route in terms of how a Recommender's financial interest should be considered. The Summer Meeting Suitability Draft requires that the Recommender not place the Recommender's financial interest **above the consumer's interest**. The TN DOCI suggest that "[a]ny recommendation made to the particular consumer shall be made without placing the financial or other interests of the [the Recommender] **ahead of the consumer's interests** as known from the consumer's suitability information."

The slight differences in route appear to cause all riders to exit the trail at the same place.

- Should the Suitability Model include the following various additional clarifications?
 - there is no requirement to recommend the best or cheapest product;
 - no particular form or type of compensation arrangement or distribution model is required or prohibited; and

- o there is no continuing obligation to the consumer after the recommended annuity is issued.

Insurer's Oversight Requirements

The Summer Meeting Suitability Draft made only one material change to an insurer's oversight requirements. It added a requirement that the insurer "maintain reasonable procedures to assess, prior to or upon issuance or delivery of an annuity, whether a producer has provided to the consumer all [the disclosures required by the Summer Meeting Suitability Draft]."

Additional Safe Harbor for "Specified Fiduciary"

The Summer Meeting Suitability Draft includes for discussion a suggestion to include as a new safe harbor "sales made by a specified fiduciary in compliance with applicable U.S. Securities and Exchange Commission (SEC) and/or federal banking requirements." The suggestion also provided the following definition for specified fiduciary:

"Specified fiduciary" means an entity acting, registered, and regulated under a fiduciary standard of care as: (1) a bank; (2) a trust company; or (3) an investment adviser under the Investment Advisers Act of 1940 or equivalent state law, and a person acting as an associated person of a specified fiduciary.

Additional Recommendations from the NY DFS

The Summer Meeting Suitability Draft includes for discussion two suggestions from the NY DFS, which has been leading the pack as it already finalized its Suitability and Best Interests in Life Insurance and Annuity Transactions Regulation (New York Suitability and Best Interests Regulation). First, it suggested prohibiting a producer from "stat[ing] or imply[ing] to the consumer that a recommendation to enter into a sales transaction is financial planning, comprehensive financial advice, investment management or related services unless the producer has a specific certification or professional designation in that area. A producer shall not use a title or designation of financial planner, financial advisor or similar title unless the producer is properly licensed or certified and actually provides securities or other non-insurance financial services."

Second, the NY DFS suggested that the Suitability Model apply "to every producer who has participated in the making of a recommendation and received compensation as a result of the sales transaction, regardless of whether the producer has had any direct contact with the consumer." It should be noted that in the final version of the New York Suitability and Best Interests Regulation, this section was revised to only apply to those producers who have "materially participated" in making the recommendation.

The insurance industry may have to endure some rocky trails as the Suitability WG pushes to the finish line to finalize the Suitability Model and possibly incorporate the items still up for discussion. We will continue to monitor the activities of the Suitability WG and other suitability and best interest initiatives.