Analysis of the 2020 Amendments to the NAIC Suitability in Annuity Transactions Model Regulation

After two years of extensive discussion, in early 2020 the NAIC adopted amendments to its Suitability in Annuity Transactions Model Regulation (the Model), which regulates recommendations and sales of all annuities (fixed and variable). The revised NAIC Model significantly enhances consumer protections and requires financial professionals, and insurers where no producer is involved (both hereafter referred to as "producers"), to act in the best interest of annuity purchasers and not put their own financial interests ahead of the consumers' interest. The amended Model, which aligns well with the SEC's Regulation Best Interest, will raise the standard of care required of financial professionals while preserving consumers' access to valuable financial advice, services and products. NAIFA was an active participant in the NAIC's deliberations and supports the amended Model regulation. The adoption by the states of these amendments is a top advocacy priority for NAIFA.

This paper will discuss the key amendments which were made to the Model and how these amendments differ from language in prior versions of the Model.

1. Requirement to Act in the Best Interest of the Consumer. The primary purpose for amending the Model was to replace the existing "suitability" standard of care—which required producers/insurers, when recommending the purchase of an annuity, to "have reasonable grounds for believing that the recommendation is suitable for the consumer"—with an enhanced standard of care that now requires producers, when recommending an annuity, to i) "act in the best interest of the consumer", ii) "under the circumstances known at the time the recommendation is made", iii) "without placing the producer's or insurer's financial interest ahead of the consumer's interest." (Section 6A)
    a. The determination of whether a producer acted in the client's best interest is not to be evaluated using hindsight or factors/circumstances that were not known at the time the recommendation was made, and the best interest obligation is a 'snapshot' standard that generally does not create a continuing obligation beyond the time the recommendation was made. (Section 6A (1)(i)).

b. The use of the language “without placing the producer’s or insurer’s financial interest ahead of the consumer’s interest” rather than stating the producer must act “without regard to” the producer’s financial interest is significant. The “without regard to” wording is typically used with a fiduciary duty standard; it is generally thought that it would be extremely difficult if not impossible for a producer operating under a commission-based brokerage business model to make a recommendation that is “without regard to” the producer’s financial interest. In addition, new language in the model expressly states that the best interest standard does “not create a fiduciary obligation or relationship.” (Section 6A(1)(d)).

c. The ‘best interest’ standard and related obligations set forth in Section 6A also apply to every producer who has “exercised material control or influence in the making of a recommendation and has received direct compensation as a result of the recommendation or sale.” (Section 6A (5)). While the exact scope of this provision has not been spelled out in detail, the drafters did indicate that it is not intended to encompass situations where a producer simply want to ‘pick the brain’ of a more senior agent or get another agent’s thoughts on a possible recommendation.

2. When is a Recommendation in the Best Interest of the Consumer? What, exactly, does it mean to act in the ‘best interest’ of the client? How will it be determined whether the producer did, in fact, act in the client’s ‘best interest’? The amended Model states that a producer will have acted in the ‘best interest’ of the consumer if the producer satisfies four obligations: care; disclosure; conflict of interest; and documentation. (Section 6A). What exactly do these obligations consist of and require of the producer?

   a. The ‘care obligation’ requires the producer to “exercise reasonable diligence, care and skill” to: know the consumer’s financial situation/ goals and insurance needs and to have a ‘reasonable basis’ to believe the product being recommended will address these factors; make a reason inquiry into the product options available and understand the ‘mechanics’ and features of these options; and communicate to the client the basis for the recommendation being made. (Section 6A (1)(a)).

    i. To meet these requirements, the produce needs to make 'reasonable efforts' to gather certain specific information from the consumer prior to making a recommendation. This information is called "consumer profile information" and consists of 14 specific items, including age, annual income, liquidity needs and existing assets. (Sections 6A(1)(b); 5C).
    ii. The amended Model also contains several provisions that 'protect' the producer and serve to limit his/her obligations under the model:
        1. The producer does not have to consider or analyze products that he/she is not authorized or licensed to recommend or sell (Section 6A (1)(c));
        2. As stated above, the 'best interest' standard does not create a fiduciary duty or relationship (Section 6A (1)(d));
        3. These requirements do not mean that the producer must recommend the product with the lowest compensation structure (Section 6A (1) (h));
        4. These requirements do not create an ongoing obligation to monitor the investment or product. (Section 6A (1)(i)).
b. The '<u>disclosure obligation</u>' requires the producer, prior to making the recommendation or sale, to disclose to the consumer: the nature of the relationship between the producer and consumer; which products the producer is licensed to sell; whether the producer is authorized/appointed to sell the products of one insurer or multiple insurers; the sources and types of compensation the producer will receive and whether she will be compensated by commission or fee; and that the consumer can request additional information about the producer's compensation. (Section 6A (2)(a)).
    i. If the consumer asks for additional information about compensation, the producer must provide a reasonable estimate of the amount of compensation—expressed as a range of dollar amounts or percentages--and whether the compensation will be paid in a single amount or spread over multiple payments. (Section 6A (2)(b)).
    ii. While it isn't a specific required item of disclosure, the producer must have a reasonable basis to believe that the consumer has

been informed of the various features of the annuity and the fees associated with the product. (Section 6A(2)(c)).

c. The <u>‘conflict of interest’ obligation</u> requires the producer to “identify and avoid or reasonably manage and disclose material conflicts of interest”. (Section 6A (3)).
    i. A “material conflict of interest” is defined as “a financial interest of the producer…that a reasonable person would expect to influence the impartiality of a recommendation.” (Section 5(i)(1)).
    ii. During the NAIC’s drafting process, NAIFA was concerned that this definition of “material conflict of interest” would create a situation that would lead to all compensation received by the producer potentially being characterized as a “material conflict of interest” (along with the negative connotations that go with this term) and therefore result in the required disclosure of all compensation. We had recommended that to resolve this concern the following language be added at the end of this definition: “provided, however that ‘material conflict of interest’ does not mean or include the compensation typically received by the producer for the marketing, sale and service of an annuity.” Although the NAIC did not include our recommended language, they did address our concern by adding new language to this definition which states that “’Material conflict of interest’ does not include cash compensation or non-cash compensation.” (Section 5(I)(2)).

d. Finally, the <u>‘documentation obligation’</u> requires the producer to make a written record of any recommendation made, including the basis for the recommendation. (Section 6A(4)(a)). If the consumer either refuses to provide the consumer profile information or decides to proceed with an annuity transaction that isn’t based on the producer’s recommendation, the producer has to obtain a statement to this effect signed by the consumer. (Section 6A (4) (b, c)).

3. <u>What if the Consumer Won’t Provide Profile Information or Won’t Follow the Recommendation?</u> This section of the Model is largely unchanged from the language in the prior version of the Model.

a. The Section 6A requirement to act in the best interest of the consumer does not apply: to any transaction where no recommendation is made; when the recommendation was based on inaccurate/misleading information provided by the consumer; if the consumer refuses to provide consumer profile information and the transaction is not recommended; or if the consumer decides to enter into a transaction that is not based on the producer's recommendation. (Section 6B (1)).
b. In the situations set forth in Section 6B (1), the applicable standard is that the issuance of the annuity must be 'reasonable' given the information and circumstances actually known at the time. (Section 6B (2)).

4. Insurers Must Establish/Maintain a Supervision System. Except as discussed in (3) above an insurer may not issue a recommended annuity unless it has a reasonable basis to believe the annuity would "effectively address the particular consumer's financial situation, insurance needs and financial objectives" based on the profile information provided. To meet this requirement, an insurer must establish and maintain a supervision system that meets certain criteria spelled out in the amended Model. (Section 6C).
   a. An insurer's supervision system must: include procedures to inform its agents of the requirements of the Model and reference these requirements in any producer training materials; have standards for producer training and require its producers to comply with the required training; have product-specific training and materials that explains an annuity's features to producers; have procedures to review each recommendation prior to issuance; have procedures to detect recommendations that do not comply with the Model's requirements; and have procedures to eliminate sales contests/quotas/bonuses that are based on the sale of specific annuities within a specific time period. (Section 6C (2))
      i. The model expressly states that the limitation on sales contests/quotas/bonuses does not generally prohibit incentives for the sales of a company's products, as long as they are not based on the sale of a specific product within a specific time period. (Section 6C (2) (h, and drafting note)).

    ii. The limitation on sales contests/quotas/bonuses does not prohibit an insurer from providing health insurance, office space or support, retirement benefits or other employee benefits as long as those benefits are not based upon the amount of sales of a specific annuity within a particular time period. Section 6C(2)(h)).

  b. An insurer is allowed to contract with a third-party vendor for performance of these supervision functions, but the insurer is responsible for monitoring the actions of any third party it uses and is responsible for compliance by any such third party with the requirements of the Model. (Section 6C (3)).
  c. An insurer is only responsible for supervising recommendations of products offered by that insurer and must only consider/compare the recommended product against other products offered by that insurer. (Section 6C (4)).

5. <u>What if the Recommendation Complies with Another Regulatory Standard (i.e., is there a 'Safe Harbor')</u>? The prior version of the Model contained a much narrower safe harbor provision: only sales that complied with FINRA requirements regarding the suitability and supervision of annuity transactions were eligible for the safe harbor. Under the amended Model, a recommendation by a "financial professional" that complies with business rules, controls and procedures that satisfy a "comparable standard" will satisfy the requirements of the Model. (Section 6E).
   a. A "financial professional" means a producer who is "regulated and acting" as a registered representative of a broker-dealer; an investment adviser representative associated with a federal/state registered investment adviser or a plan fiduciary under ERISA or the Internal Revenue Code. (Section 6E (4)).
      i. The "regulated and acting" wording means the producer must be explicitly acting in compliance with the applicable "comparable standard" in order to be eligible for the safe harbor.
   b. A "comparable standard", for purposes of determining whether activities are eligible for the safe harbor, means: for broker-dealers and registered representatives, applicable FINRA and SEC rules that

address best interest obligations and supervision of annuity recommendations and sales (such as Regulation Best Interest); for investment advisers and investment adviser representatives, the fiduciary duty imposed by the Investment Adviser Act of 1940 or state securities law; and for plan fiduciaries, the duties and prohibitions found in ERISA or the IRC. (Section 6E (5)).

c. Even if eligible for a safe harbor, the insurer is still responsible for complying with the Section 6C(1) obligation to be sure that it does "not issue an annuity recommended to a consumer unless there is a reasonable basis to believe the annuity would effectively address the particular consumer's financial situation, insurance needs and financial objectives based on the consumer's consumer profile information." (Section 6E (2)).

d. In terms of a 'bottom line' with respect to the safe harbor, those eligible for the safe harbor will be deemed to be in compliance with the various specific requirements and duties of the Model, such as satisfying the four obligations that make up the best interest determination and the various supervision specifics in Section 6C(2). However, the overriding responsibility of the insurer under Section 6C(1) to not issue a recommended annuity "unless there is a reasonable basis to believe the annuity would effectively address the particular consumer's financial situation, insurance needs and financial objectives based on the consumer's consumer profile information" remains a continuing obligation separate and apart from eligibility for and applicability of any safe harbor.

6. <u>Are there any Changes to the Existing Producer Training Requirements</u>? Previous versions of the Model contained detailed producer training requirements. The amended Model retains these requirements and adds in additional provisions regarding training in the new/revised requirements made by the amendments to the Model.

    a. Remaining unchanged are requirements that a producer cannot recommend or sell an annuity without adequate knowledge of the product(s) and without meeting the insurer's standards for product training. In order to sell annuity products a producer must successfully

complete a one-time four credit training course approved by the state insurance department. (Section 7).

   b. A producer who completed the required four credit training course prior to the effective date of the amended Model in his/her state must, within six months of the effective date of the amended Model, complete a one-time, one credit course on the sales practices and disclosure requirements under the amended Model. (Section 7B (6)).

7. Who is Responsible for Compliance with the Requirements of the Model? Who is Liable if a Recommendation is Not in the Best Interest of the Consumer? The amendments to the Model do not make any substantive changes to this section of the Model.
   a. Section 8A states that "An insurer is responsible for compliance with this regulation". The commissioner can require the insurer to take corrective measures for any consumer harmed by the insurer's or its producers' failure to comply with the Model's requirements. (Section 8A (1)).
   b. The insurer's overall liability does not relieve the producer of responsibility: the commissioner is generally authorized to impose appropriate penalties and sanctions and to order the agency and/or producer to "to take reasonably appropriate corrective action for any consumer harmed by the insurance producer's violation of this regulation." (Section 8A (2)).

(4/20)