Adopted by the Contingent Deferred Annuity (A) Working Group, 11/19/15
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GUIDANCE FOR THE FINANCIAL SOLVENCY AND MARKET CONDUCT REGULATION OF INSURERS THAT OFFER CONTINGENT DEFERRED ANNUITIES

Executive Summary

In late 2012, the Life Insurance and Annuities (A) Committee charged the Contingent Deferred Annuity (A) Working Group with evaluating the adequacy of existing laws and regulations with regard to contingent deferred annuities (CDAs) and whether additional solvency and consumer protection standards were required. The Working Group determined that CDAs do not fit into the categories of fixed or variable annuities and, therefore, do not always easily fit in existing laws and regulations governing annuities.

The purpose of this guidance is two-fold: 1) to serve as a reference for the states that are interested in modifying their annuity laws to clarify their applicability to CDAs; and 2) to help the states determine how to apply their existing annuity laws and rules to CDAs. This guidance sets forth the consumer protection and financial solvency-related NAIC model laws and regulations that should and should not be applied to CDAs. The guidance outlines what revisions, additions and regulatory interpretations a state may wish to consider in determining how existing state laws governing annuities apply to these products. This guidance also references regulatory guidance developed by the Financial Condition (E) Committee, the Life Risk-Based Capital (E) Working Group and the Life Actuarial (A) Task Force for the states to use in evaluating capital and reserving requirements. This guidance is intended to provide a general framework for the regulation of CDAs, while work on specific issues involving CDAs continues at the NAIC.

In the course of completing its charges, the Working Group met with, and heard discussion from, the life insurance industry, interested trade groups, consumer representatives, the U.S. Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), the U.S. Department of Labor (DOL), the American Academy of Actuaries (Academy), the U.S. Government Accountability Office (GAO) and the National Organization of Life and Health Guaranty Associations (NOLHGA), among other interested parties. This guidance is based on the information provided by these parties, in addition to the Working Group's review of existing NAIC model laws and regulations.

I. Background

A. Classification of CDAs

In 2012, the Contingent Deferred Annuity (A) Subgroup reviewed CDAs to determine how these products should be classified. In March 2012, the Life Insurance and Annuities (A) Committee, as well as the Executive (EX) Committee and Plenary, adopted the recommendations of the Subgroup that CDAs are annuities best written by life insurers.

B. Definition of "Contingent Deferred Annuity"

The Working Group drafted, and the NAIC membership adopted, a definition of a CDA as "an annuity contract that establishes a life insurer's obligation to make periodic payments for the annuitant's lifetime at the time designated investments, which are not owned or held by the insurer, are depleted to a contractually defined amount due to contractually permitted withdrawals, market performance, fees and/or other charges." State insurance regulators should consider this definition when determining whether a product is properly classified as a CDA. If revisions to statutes and/or regulations are contemplated, the states may wish to add this definition to their statutes and/or regulations.

C. Features of a CDA

A CDA is an insurance product providing protection against both investment risk and longevity risk. A lifetime income guarantee is provided by the insurer to protect the insured's[1] external investment accounts from underperforming and downward performing markets. This lifetime income guarantee also provides longevity risk protection by guaranteeing that income will continue for life, even if withdrawals were eventually to lead to the depletion of their external investment accounts.

A CDA can be generally thought of as a living benefit added to an investment account, such as a mutual fund or a managed account (known as a "covered investment"). The insurer provides an income guarantee through the collection of fees from within these external covered investments. The underlying account is not held or managed by the insurer, but is instead held by a related or unrelated third party. The insurer contractually restricts the type of covered investments that can be covered by the CDA, but the insurer does not control the covered investments. The insured must agree to certain portfolio restrictions and must first deplete their external covered investments at the CDA guaranteed income amount according to the contractually permitted withdrawals and prior to the insurer's assumption of this lifetime income payment stream. An example of this would be a CDA attached to a mutual fund held in an individual or employer-sponsored retirement account. The CDA issuer can contractually limit the CDA's attachment to certain allowable mutual funds, but would have no control over the assets that make up those mutual funds.

1. Accumulation Phase

A CDA has three distinct phases during the life of the contract: 1) accumulation; 2) withdrawal; and 3) payout. First, the CDA goes through an accumulation phase. This phase occurs from the date the CDA is issued until the time the insured decides to take withdrawals from the covered investments, typically upon reaching a certain age such as retirement age. During this phase, the CDA benefit base (i.e., a notional amount used for calculating permitted withdrawals and the benefit amount) is typically determined by the value of the covered investments.[2] As those assets increase in value (e.g., through investment gains or additional deposits), the CDA benefit base amount increases. The CDA benefit base may also increase due to contractual features. Depending on the product design, the benefit base is calculated on a daily, monthly or annual basis. The more frequently the benefit base calculation is made, the more likely an insured will realize increases in the benefit base.

Once a benefit base amount has been set, the CDA guarantees that the benefit base can never decrease due to declines in the value of covered investments as the result of investment losses. This allows the insured to mitigate the risk that future withdrawal amounts will decrease due to market conditions. The insurer assumes some of the market risk of the covered investments by guaranteeing periodic withdrawal amounts based on the benefit base, which may be greater than the actual value of the covered investments held at the time of withdrawal.

[1] In this guidance, "insured" is used to refer generally to the person or persons who purchased the CDA benefit and is used synonymously with "consumer," "annuitant," "contract holder," etc.
[2] A benefit base could also be calculated as premium "rolled up" at a specified rate.

2. Withdrawal Phase

The second phase of the CDA is the withdrawal phase. The withdrawal phase occurs when the insured elects to begin to draw funds from the covered investments after reaching the age specified in the CDA contract, most typically retirement age. Some product designs may allow insureds to elect to begin withdrawals at an earlier or later age, in which case, the percentage of the benefit base permitted for withdrawals may be adjusted up or down accordingly. During the withdrawal phase, no benefit payments are made under the CDA and the insured is making withdrawals solely from the covered investments.

The "guaranteed withdrawal amount" under the CDA is the maximum withdrawal that an insured may take without penalty. Withdrawals at or below the guaranteed withdrawal amount do not affect the amount of future withdrawals. However, should an insured withdraw funds above the contractually permitted amount, a pro rata reduction of the CDA benefit base and/or the guaranteed withdrawal amount may occur. Excessive withdrawals could also result in termination of the CDA. Under current product designs, the guaranteed withdrawal amount is based on a specified percentage of the value of the CDA benefit base at the time distributions begin.

During the withdrawal phase, an insured still maintains his or her assets in the covered investments. Thus, the value of the covered investments may increase or decrease during the withdrawal phase due to market conditions. However, the guaranteed withdrawal amount will not decrease due to loss of value of the covered investments, although such losses could have the effect of triggering payments earlier under the CDA, if the loss of value of the covered investments caused the insured to completely deplete the covered investments. Consequently, insurers will typically offer CDAs in connection with covered investments that can be effectively hedged.

3. Payout Phase

The third and final phase is the payout or settlement phase. Upon exhaustion of the covered investments, the insurer begins making periodic payments equal to the guaranteed withdrawal amount for the insured's lifetime.[3] In this way, the CDA guarantees lifetime income payments during retirement.[4] It is the Working Group's understanding that the CDA products sold to date do not include a death benefit. Because an insured is limited in the amount of periodic withdrawals he or she may take during the withdrawal phase, whether or not a CDA will reach the payout or settlement phase is a function of the performance of the covered investments, increases to the CDA benefit base, insured behavior (e.g., risk/return selection among covered investments) and the insured's longevity (i.e., whether the covered investments will be sufficient to fund withdrawals before the insured dies).[5]

For the CDA products the Working Group reviewed, the fee for the CDA policy was calculated as a percentage of the covered investments or benefit base.[6] Generally, the fee is deducted from the covered investments.

D. Federal Regulation of CDAs

The SEC has not taken a position regarding whether CDAs are required to be registered as securities under the federal Securities Act of 1933. However, based on information received from the SEC, it is the Working Group's understanding that a product whose value derives from a registered security (e.g., a retail mutual fund that is registered with the SEC under the federal Investment Company Act of 1940) is also considered a security requiring registration, unless a specific registration exemption applies. In cases where a CDA's value is derived from the value of an underlying registered security, it would appear that CDAs need to be registered with the SEC. It is the Working Group's understanding, based on its discussions with the life insurance industry, that insurers have been registering CDA products with the SEC to date, unless the CDA qualifies for one of the designated exemptions from SEC registration in the federal securities laws. An important exemption, for instance, is the exemption from SEC registration for annuities that fund certain retirement plans. CDAs structured as group annuities offered to 401(k) plans and similar plans typically rely on this exemption. Insurers should continue to discuss registration requirements for CDA products with the SEC.

[3] A payout structure could alternatively be based on a joint life or "life with period certain" structure.
[4] Payments may be level or increasing depending on product design.
[5] For some CDA products, an insured may elect to purchase spousal benefits. In these instances, the CDA would be subject to the longevity of both spouses.
[6] As the value of the covered investments increase, the dollar amount of fees and the guaranteed withdrawal amount will increase.

If a CDA is registered with the SEC, the CDA may only be sold through a FINRA-licensed broker-dealer. Sales of CDAs through broker-dealers are subject to FINRA's general suitability requirements. Registered investment advisors may recommend, but not sell, the CDA.[7] Registered investment advisors owe a fiduciary duty to their clients in recommending any investment product, and a CDA purchase would be required to be made through a broker-dealer. Registered CDAs are subject to SEC disclosure requirements, including the delivery of a prospectus, and FINRA's advertising and marketing rules. Non-registered CDAs are not subject to these requirements, but state-specific requirements, such as suitability and disclosure requirements, would apply.

II. Financial Regulation of CDAs

A. Risk Management

The design of CDAs and their relationship to investments outside of the insurer's control create risks that necessitate strong and comprehensive risk-management practices by insurers. State insurance regulators should review a CDA insurer's risk-management program as it relates to the following areas: longevity risk; investment risk; policyholder behavior risk; and third-party risk.

1. Longevity Risk

Longevity risk is one of the main risks that CDAs transfer from the policyholder to the insurer. This is the risk that policyholders will live beyond their anticipated life expectancy, deplete their covered investments and trigger the CDA lifetime income benefit. This risk can be managed by the insurer through product design, risk pooling and risk-management techniques that are similar to those used in other life products with longevity risk. State insurance regulators reviewing an insurer's handling of longevity risk should look to the insurer's actuarial opinions to ensure that it is properly reserving for longevity risk.

2. Investment Risk

Another risk that is transferred to the insurer from the insured is investment risk. The investment risk associated with a CDA is that the amount of benefit to the insured varies inversely to the market performance of the covered investments. Due to poor market performance of the covered investments, the value of the covered investments may decrease, while the benefit base and associated guaranteed withdrawal amount remain at a higher level. Under this scenario, when the insured takes the guaranteed withdrawal amount, it is more likely the insured will deplete the covered investments and trigger the CDA benefit. For example, a large downturn in the stock market could reduce the value of the covered investments underlying the CDA, but the CDA benefit base would remain locked in at a higher value, thus increasing the likelihood that the CDA will reach the payout phase.

Insurers can manage investment risk by developing comprehensive hedging strategies similar to those used to manage the investment risk associated with other life and annuity products; that is, investing in an offsetting position in assets related to those in which the insurer incurs the investment risk (e.g., derivatives). Of course, hedging cannot offset all investment risks and is only a method for mitigating losses and results will vary depending on hedge effectiveness. Further, in the event there is a significant, broad-based market downturn, such as the 2008 financial crisis, CDA issuers may experience a greater-than-anticipated number of CDAs entering the payout phase because of a high number of insureds suffering losses in the underlying covered investments. State insurance regulators may wish to review an insurer's hedging strategy to verify that it is comprehensive, it appropriately addresses the insurer's investment risks under adverse scenarios, and that an insurer is making reasonable assumptions regarding the effectiveness of the hedging strategy. An insurer must have a "clearly defined hedging strategy" to take credit for hedging in reserving (pursuant to *Actuarial Guideline XLIII—CARVM for Variable Annuities* (AG 43)) and RBC calculations (pursuant to C-3 Phase 2).

3. Policyholder Behavior Risk

CDA issuers also incur risks based on insured behavior, including lapse rates, investment decisions, and the amount and timing of withdrawals. In this regard, the value of the CDA to an insured—and, correspondingly, the level of risk to the insurer—is, in many ways, governed by insured behavior. An insured may wish to place his or her assets in more volatile

[7] Investment advisors who manage less than $100 million in assets must register in the state of their principal place of business. Investment advisors managing assets of $100 million or more must register with the SEC.

investments (i.e., investments with the greatest potential gain or loss), because if the investments increase in value, the increase is added to the CDA's benefit base; if, however, the investments decrease in value, the benefit base is locked in at the portfolio's peak. From the insured's risk perspective, investment increases mean a higher benefit base and investment losses mean the CDA reaches the payout phase sooner.

Similarly, whether the payout phase will be reached also will depend, in part, on insured behavior and, in particular, when the insured commences withdrawals and whether the insured takes the maximum allowable withdrawal amount. An insured would achieve the maximum benefit under a typical CDA by taking the maximum allowable withdrawal amount each year in order to draw down the covered investments and trigger the payout phase of the CDA. Insurers can manage policyholder behavior risk through product design in several ways: 1) including restrictions on the type of investment assets that an insured may use with a CDA; 2) limiting withdrawal amounts during the withdrawal phase; 3) varying fees in accordance with the risk level of the covered investments; and 4) decreasing benefits in the payout phase for withdrawals above the guaranteed withdrawal amount during the withdrawal phase or for withdrawals made during the accumulation phase.

State insurance regulators should review CDA products with a balanced view, ensuring that CDAs are designed to manage policyholder behavior risks while not being overly restrictive in how insureds may use and gain value from a CDA.

4. Third-Party Risk

Insurers that offer CDAs must also manage third-party relationships and risks. Insurers establish the terms and conditions of the CDA but work with third-party non-insurers that manage the covered investments. These third parties may collect the CDA fee, provide information regarding covered investments' performance (for determining the CDA benefit base) and notify the insurer if the insured changes the assets contained in the underlying account (to determine if the insured is invested in assets allowed under the CDA contract). If an insurer does not receive timely information from the third-party asset manager, it will be difficult for the insurer to administer the CDA. Insurers will likely need to contract with these third parties to clarify each party's roles and responsibilities. Similarly, insurers face counterparty risks from the parties from whom they buy hedge instruments, specifically, whether the counterparty will back the guarantees it offers.

B. Risk Management Checklist

The Financial Condition (E) Committee has been charged with developing a checklist for state insurance regulators to use in reviewing the risk-management program of insurers wishing to offer CDAs. As of the date of adoption of this guidance, work on this checklist was pending.

C. Reserve Requirements

The Life Actuarial (A) Task Force has determined that reserving for CDAs should be conducted in accordance with AG 43 and that no changes are required at this time. The Task Force also concluded that there is no need for any clarifying guidance due to differences in nomenclature between CDAs and variable annuities with guarantees. The Task Force found that CDAs are similar enough to variable annuities with guaranteed lifetime withdrawal benefits to apply the same reserving framework. The Task Force advised that any future reviews and revisions of AG 43 should evaluate its appropriateness to all products within its scope, including CDAs.

D. Capital Requirements

The Life Risked-Based Capital (E) Working Group has reached the preliminary conclusion that CDA capital requirements should be determined using C-3 Phase II. As of the adoption of this guidance, no changes to C-3 Phase II were anticipated to address CDAs, but changes may be considered after reviewing the work of other NAIC groups that are reviewing financial requirements for CDAs.

III. Nonfinancial Regulation of CDAs

The Working Group examined existing consumer protection laws and regulations to determine how CDAs best fit within the current regulations that apply to fixed and variable annuities. In conducting this review, the Working Group determined that CDAs do not fit neatly into either one of these categories. For example, the value of a CDA is determined, in part, by the market performance of the covered investments, similar to how the value of a variable annuity is determined by the performance of a separate portfolio. Further, CDAs, if registered with the SEC, are subject to federal securities regulation. On

the other hand, a CDA resembles a fixed annuity, in that a CDA benefit consists of fixed, periodic payments upon annuitization or depletion of the underlying assets. Additional confusion has been caused by CDA products being filed with the states as both fixed and variable annuities. Because a CDA shares qualities of both a fixed and variable annuity, the Working Group concluded that a CDA should not be classified in either category but instead belongs in its own category.

A. Filing Requirements

The Working Group recommends that CDAs be filed with the states as "contingent deferred annuities" and not as fixed or variable annuities. Based on this recommendation, "contingent deferred annuities" has been added as a filing category in the NAIC System for Electronic Rate and Form Filing (SERFF). In this regard, a group and individual category has been established in SERFF for CDAs under type of insurance (A07G Group Annuities – Special / A07G.003 Contingent Deferred and A07I Individual Annuities – Special / A.07I.003 Contingent Deferred).

B. Application of NAIC Model Laws and Regulations

The Working Group reviewed which nonfinancial NAIC model laws and regulations should apply, or not apply, to CDAs. The Working Group's findings are outlined below, along with recommendations about how the states could interpret and/or amend their existing annuity laws and/or regulations.

1. *Producer Licensing Model Act* (#218)

The *Producer Licensing Model Act* (#218) governs the qualification requirements and procedures for licensing insurance producers. The Producer Licensing (EX) Task Force has reviewed Model #218 and determined that "producers selling CDAs should be required to obtain a securities and variable lines license." The Task Force did not recommend any revisions to the Model #218. For CDAs that are registered as securities, state insurance regulators should verify that producers have the requisite licenses and registration required to sell securities.

2. *Annuity Disclosure Model Regulation* (#245)

The *Annuity Disclosure Model Regulation* (#245) requires insurers that sell annuities to provide a disclosure document and a buyer's guide in connection with the sale of an annuity. Model #245 applies broadly to all annuity contracts but exempts specific types of annuities, including those registered with the SEC or issued to employer-sponsored retirement plans, which may have their own disclosure requirements that preempt state law (see Section 3 of Model #245). Because CDAs generally fall within one of these two categories, the Working Group found that the exemption in Model #245 for registered products and employer-sponsored plans would apply to CDAs. To the extent there are any CDA products that do not fall within one of these two exceptions, the disclosure requirements outlined in Section 5B of Model #245 would apply.

Under Model #245, the NAIC buyer's guide is required to be provided in the sales of variable annuities "and when appropriate, in sales of other registered products." Currently, the NAIC does not have a buyer's guide that addresses CDAs. Providing the current buyer's guide for fixed and variable annuities, which is inapplicable for CDAs, may confuse consumers. Therefore, the Working Group concluded that the requirement to provide a buyer's guide would not be appropriate for CDAs. A drafting note was added to Model #245 and adopted by the NAIC membership that states, "[t]he requirement to provide a Buyer's Guide would not be appropriate for contingent deferred annuities unless, or until such time as, the NAIC adopts a Buyer's Guide that specifically addresses contingent deferred annuities."

The states should review their annuity disclosure laws and regulations to determine if they need to be revised to clarify when the disclosure requirements do not apply to CDAs. The NAIC has adopted a change to Model #245 that adds a definition of "registered products" and has added a drafting note that registered products would include registered CDAs. The exemptions in Model #245 for registered products and products issued to employer-sponsored plans may be broad enough for the states to interpret existing law to exclude CDAs without revision to existing regulations.

3. *Suitability in Annuity Transactions Model Regulations* (#275)

The Working Group determined that the *Suitability in Annuity Transactions Model Regulation* (#275) should apply to CDAs and that suitability review for the sale of CDAs is an important consumer protection for these products. Section 6H(1) of

Model #275 has a "safe harbor" provision that provides that sales made in compliance with FINRA requirements "pertaining to suitability and supervision of annuity transactions" satisfy the requirements of Model #275.[8] The NAIC adopted a revision to this section of the model to clarify that the safe harbor provision applies to all types of annuities, which would include CDAs. Thus, if FINRA's variable annuity suitability rules are applied to registered CDAs or CDA-specific suitability rules are developed by FINRA in the future, that suitability review would be considered to be in compliance with Model #275.

That being said, FINRA indicated to the Working Group that it will not require broker-dealers to apply the suitability standards for variable annuities to CDA sales, although FINRA general suitability requirements would apply. If a broker-dealer does not apply FINRA's annuity suitability standards to the sale of a CDA, then the safe harbor provision would not be applicable and the suitability requirements of Model #275 would apply. However, individual broker-dealers may apply FINRA annuity suitability standards to CDAs, despite FINRA not requiring it, and that would be sufficient for the safe harbor provision to apply. State insurance regulators should ensure that sales of CDAs are subjected to suitability review either under FINRA standards or state-specific standards. If a suitability review is not conducted under FINRA's suitability standards, then the suitability requirements of Model #275 would apply.

For sales governed by Model #275, the Working Group concluded that the existing list of "suitability information" included in Section 5I of Model #275 contains all the information that is needed to examine the suitability of a CDA sale, and additional factors do not need to be added to Model #275 to specifically address CDAs. The NAIC also adopted changes to Section 7 of Model #275 to clarify that training requirements would include the product-specific features of all types of annuity contracts, including CDAs.

4. *Life and Health Insurance Guaranty Association Model Act* (#520)

The Receivership and Insolvency (E) Task Force reviewed whether revisions to the *Life and Health Insurance Guaranty Association Model Act* (#520) were needed and warranted to address CDAs. After presentations from NOLGHA, discussions with Task Force members and comments from interested parties, the Task Force found that CDAs would fall within the definition of "annuity" in Model #520 and be subject to the same provisions for coverage, group and individual, and subject to the same limitations and broad exclusions, as other annuities. This finding was based on the assumption that CDAs are considered annuities under state law and the issuer is a member insurer under state guaranty association law.

Subject to the fact that individual state insurance departments and guaranty associations always have the ultimate decision of what contracts are covered, the Task Force has determined that, in those states that meet the above assumptions, CDAs should be covered annuities, both in the pre-payout phrase and the payout phrase, subject to all of the other statutory limits and exclusions that apply generally to annuities.

5. *Advertisements of Life Insurance and Annuities Model Regulation* (#570)

The *Advertisements of Life Insurance and Annuities Model Regulation* (#570) sets forth standards for the advertisement of life insurance products. The Working Group determined that this regulation is applicable to CDAs. This regulation currently applies to "annuities," which the Working Group determined was broad enough to encompass CDAs. Section 3A of Model #570 states that where federal regulations establish disclosure requirements, this regulation is interpreted to avoid conflicts with federal regulation. The Working Group believes this section should also apply to CDAs when they are registered and subject to federal disclosure requirements. The NAIC has adopted a revision to Section 3A to clarify that this section applies to all registered products, which would include registered CDAs. The states should review their existing regulations and consider clarifying their regulations or issuing guidance that this regulation would apply to CDAs. The states may also wish to clarify that, in order to avoid issues of preemption, the application of these regulations to registered CDAs is not intended to conflict with federal disclosure requirements.

6. *Life Insurance and Annuities Replacement Model Regulation* (#613)

The *Life Insurance and Annuities Replacement Model Regulation* (#613) regulates insurers and producers with respect to the replacement of existing life insurance plans and annuity contracts. The Working Group concluded that Model #613 would apply to CDAs just like it would to any other annuity. Section 1C of Model #613 exempts "registered contracts" with respect to the provision of illustrations and policy summaries, because those products are subject to federal prospectus and disclosure

[8] There are other exemptions that may apply to CDAs that can be found in Section 4 of Model #275, including exemptions for certain retirement plans.

requirements.[9] The NAIC adopted revisions to the definition of "registered contracts" and a drafting note to clarify that this exemption would include registered CDAs that are subject to federal disclosure requirements.

7. *Synthetic Guaranteed Investment Contracts Model Regula*tion (#695)

The *Synthetic Guaranteed Investment Contracts Model Regulation* (#695) prescribes terms and conditions under which life insurance companies can issue contracts that "establish the insurer's obligation by reference to a segregated portfolio of assets that is not owned by the insurer." The Working Group made no findings regarding whether Model #695 would apply to CDAs, but did note that CDAs share certain characteristics with synthetic guaranteed investment contracts. The Life Insurance and Annuities (A) Committee tasked the Life Actuarial (A) Task Force with reviewing Model #695 and its relation to CDAs, and the Task Force concluded that this model regulation should not apply to CDAs. A drafting note was added to Model #695 and adopted by the NAIC that states, "[t]his regulation is not intended to apply to CDAs."

8. *Standard Nonforfeiture Law for Individual Deferred Annuities* (#805)

The *Standard Nonforfeiture Law for Individual Deferred Annuities* (#805) sets requirements and minimum values for surrender benefits due to a contract holder upon nonpayment or cancellation of an annuity contract. Model #805 applies broadly to individual annuities, unless specifically exempted. Because Model #805 broadly applies to annuities and CDAs are not specifically exempted, this law would arguably apply to CDAs. However, the Working Group determined that it was unclear how nonforfeiture benefits would be calculated for CDAs under the current law, as CDAs do not, for example, contain paid-up annuity, cash surrender or death benefits. Therefore, the Working Group recommended that the current version of Model #805 be amended to specifically exclude CDAs, because there is no method in the law for calculating nonforfeiture benefits as they would apply to CDAs and, therefore, inclusion of CDAs in this model would cause confusion. The Working Group made no recommendations as to whether nonforfeiture benefits should be required for CDAs. Proposed revisions to Model #805 to exempt CDAs were pending at the NAIC as of the date of adoption of this guidance.

IV. Other Consumer Protection Issues

A. Cancellation

During the Working Group's review of CDAs, concerns were raised by Working Group members regarding scenarios where a CDA contract could be cancelled before the payout phase, resulting in the loss of the CDA benefit. The Working Group identified two types of scenarios in which a CDA contract could be cancelled:

1. Cancellation of the contract as a result of action by the insured based on the terms of the contract. The most obvious examples of this would be an insured electing to surrender the CDA contract, failing to pay the CDA fees or violation the terms of the CDA contract.
2. Cancellation of the contract as a result of action by a financial institution (e.g., insurer, third party/investment manager).

This section focuses on consumer protections triggered in the second type of scenario; i.e., cancellation of the contract for reasons beyond the control of the insured.

While the Working Group believes these scenarios would be uncommon, the cancellation of a CDA contract may be the result of action by a financial institution. For example, if the investment manager deviates for agreed-upon investment parameters for a covered investment, the insurer can remove specific investments from its list of permitted investments. In these instances, the insured will have the option to move its investments or face cancellation of the CDA contract. Additionally, insurers often rely on third parties to remit fees under the CDA contract and provide data regarding an insured's investments and withdrawals. Failure by a third party to perform one or more of these tasks may necessitate the cancellation of the CDA contract by the insurer.[10]

[9] There are other exemptions that may apply to CDAs that can be found in Section 1B of Model #613, including exemptions for certain retirement plans.

[10] Other examples of cancellations caused by the actions of a financial institution include the expiration of the contract between the insurer and the third party, resulting in the CDA contract no longer supporting investments with that third party as a permitted covered investment. Another example may be an employer-sponsored retirement plan where the plan sponsor choses a new company to manage its employee's retirement accounts that has no contract with the CDA insurer. The insured's retirement funds would roll over into a retirement account that would not constitute a permitted covered investment. The Working Group notes, however, that ERISA and the Internal Revenue Code would apply in this scenario.

The loss of the CDA benefit could come after years of paying fees for the CDA. In this regard, a CDA provides guaranteed lifetime income and, like most other life products, the time between the insured entering the contract and collecting benefits could be years or decades. There is no payout or settlement phase until the covered investments have been exhausted and, thus, a CDA that is cancelled in the accumulation or withdrawal phase would result in no periodic payments from the insurer. Further, CDA contract fees are most typically taken from the covered investments, so the insured not only loses the amount of fees paid, but may also lose the potential investment gains that money would have generated had it not been subtracted from the covered investments. Thus, the cancellation of a CDA contract could result in a lower account value had fees not been assessed. It is important to remember that because the insurer does not hold or control the covered investments for a CDA, an insured always retains the entire amount of the covered investments in the event a CDA contract is cancelled. However, if no cancellation benefit is given, the insured could lose significant account value, future "peace of mind" benefits and lifetime income protection.

B. Cancellation Benefit

As a result of the Working Group's concerns, the life insurance industry was asked to develop a cancellation benefit that could be made available to an insured when the cancellation is not a result of action taken by the insured. The life insurance industry presented three types of cancellation benefits that could be offered to insureds: 1) replacement annuity; 2) lump sum payment; and 3) return a portion of the fees incurred by the insured.

1. Replacement Annuity

First, the life industry indicated that an insured could be offered a replacement annuity that generally replicated the CDA benefit accrued at the time of cancellation. The replacement annuity may be structured in several ways, including:

- A single premium immediate annuity.
- A deferred income annuity.
- A variable annuity with a guaranteed lifetime withdrawal benefit or a guaranteed minimum income benefit.

The insurer would design the replacement annuity to provide guaranteed annuity payments at the guaranteed withdrawal amount that was earned at the time of CDA cancellation. The type of annuity made available may depend on the stage the CDA is in at the time of cancellation.

2. Lump Sum Payment

The second type of cancellation benefit that could be made available to an insured is a lump sum payment. The insured would receive a cash payment in an amount equal to the present value of the guaranteed withdrawal amount minus the CDA account value and the present value of future fees at the time the CDA was cancelled. The present value of the guarantee would be determined according to a formula outlined in the CDA contract and filed with state insurance regulators.

3. Return a Portion of the Fees Incurred by the Insured

The third type of cancellation benefit would be a return of a portion of the fees incurred by the insured. For this benefit, the insurer would return a percentage of the fee paid by the insured, either in the form of a lump sum payment or, alternatively, as a lifetime income stream payable immediately or when the payout phase of the CDA was anticipated to begin.

The particular benefit that is appropriate for a CDA contract will depend on the design of the specific CDA contract and the market where the CDA contract is sold. It could also vary based on other factors such as the transferability of the covered investments or whether the CDA is in the accumulation phase or withdrawal phase when the cancellation occurs. For example, the option to transfer investments to a variable annuity with a guaranteed income rider will depend on whether an insured could transfer his or her covered investments to the variable annuity and whether such a transfer would be suitable. In another example, a single premium immediate annuity may be more appropriate for a CDA cancelled in the withdrawal phase and a deferred income annuity may be more appropriate for a CDA cancelled in the accumulation phase. Different approaches to the cancellation benefit may be warranted to address the reasons for, and timing of, the cancellation.

B. Working Group Recommendation

After reviewing the issue and hearing options from the industry as to how a cancellation benefit could be provided, the Working Group determined that a minimum cancellation benefit should be included in every CDA contract filed after the date this guidance is adopted by the NAIC membership. With regard to when the cancellation benefit should be available, the Working Group determined that, at a minimum, a cancellation benefit should be available where a CDA contract is cancelled for reasons other than the actions of the insured. This would include cancellation due to third-party contractual issues between the insurer and the investment manager of the covered investments. This would address situations where the insured can no longer maintain a CDA benefit because the CDA contract does not cover his or her investments.

Each CDA contract should, at a minimum, contain a CDA cancellation benefit, and state insurance regulators reviewing CDA cancellation benefits should ensure that at least one of the benefits is available to the insured. The Working Group acknowledges that one motivation for consumers purchasing a CDA may be a preference to keep their assets in an externally managed investment account, such as a mutual fund or managed account. Notwithstanding the ability of the consumer to maintain guaranteed lifetime income through an annuity cancellation option (e.g., variable annuity with guaranteed lifetime withdrawal benefits or guaranteed minimum income benefit, single premium annuity, deferred income annuity), limiting consumers to this option may run contrary to their reluctance to transfer assets to an insurer. Therefore, the Working Group recommends that when an insurer offers an annuity cancellation option, that a second option, at the insurer's discretion, be made available to the consumer. This recommendation does not apply to CDAs offered through an employer-sponsored retirement account, because the options available will be governed by the employer/fiduciary's contract with the insurer and regulations governing employer-sponsored plans. State insurance regulators should allow insurers flexibility to design a cancellation benefit that best fits their particular product design. In addition, depending on product design, it may be appropriate for insurers to offer more than one cancellation benefit option, and which option is available may also vary depending on which phase the CDA contract is in at the time of cancellation.

In addition, the CDA contract provisions and any associated disclosure document should indicate the events that could lead to cancellation of the CDA contract. The contract and associated disclosure document should specify what actions or events would lead to the insurer cancelling the CDA without providing a cancellation benefit. In addition, the CDA contract provisions and associated disclosure document should specify the scenarios where a cancellation benefit is available, an explanation as to the form of the cancellation benefit, and how the amount of the cancellation benefit is calculated. Examples drafted by the life insurance industry are attached to this guidance. The actual language filed in a product-specific form filing will differ.

State insurance regulators should enforce the requirement that a CDA contract include a cancellation benefit as a standard CDA contract requirement in each state's form filing checklists and filing guidelines. CDA form filings that do not contain a cancellation benefit that meets the minimum requirements outlined in this guidance should be disapproved pursuant to each state's form filing laws and/or regulations. The Working Group's recommendation should be viewed as a minimum requirement for the sale of this product, and state insurance regulators should consider how a cancellation benefit would best fit within their state's requirements.

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