

## Annuity Best Interest Regulatory Guidance and Considerations

### Summary

The Life and Annuity (A) Committee of the National Association of Insurance Commissioners offers the following regulatory guidance for state Departments of Insurance (DOIs) to use when reviewing a life insurer’s compliance with the *Suitability in Annuity Transactions Model Regulation*, Model 275-1 (the “Model Regulation”). The regulatory guidance is focused on offering guidance concerning insurance company obligations under the safe harbor provisions embodied in Section 6E—Safe Harbor of the Model Regulation, which provides:

Recommendations and sales of annuities made in compliance with comparable standards shall satisfy the requirements under this regulation. This subsection applies to all recommendations and sales of annuities made by financial professionals in compliance with business rules, controls and procedures that satisfy a comparable standard even if such standard would not otherwise apply to the product or recommendation at issue. However, nothing in this subsection shall limit the insurance commissioner’s ability to investigate and enforce the provisions of this regulation.<sup>1</sup>

Generally, the safe harbor would be available to an insurance producer who is also registered as a financial professional under securities law and is subject to another comparable supervisory control system as a result.

This regulatory guidance and consideration document addresses five elements of the safe harbor in the Model Regulation. First, to avail itself of the safe harbor, and to create a circumstance where an insurance producer may reasonably rely on the safe harbor, the insurance company must determine that the conditions of the safe harbor have been met. Second, in each annuity transaction the insurance company must still have “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,”<sup>2</sup> although the insurer may base its analysis on information received from either the financial professional<sup>3</sup> or

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<sup>1</sup> Section 6(E)(1). The prohibited practices in Section 6(D) still apply in Safe Harbor transactions.

<sup>2</sup> See Section 6(C)(1); see also Section 6(E)(2) (“Nothing in Paragraph (1) shall limit the insurer’s obligation to comply with Section 6(C)(1) of this regulation. . . .”)

<sup>3</sup> A financial professional is a producer that is regulated and acting as

(a) A broker-dealer registered under federal [or state] securities laws or a registered representative of a broker-dealer;

the entity supervising the financial professional. Third, for the safe harbor to apply, an insurance company must “[m]onitor the relevant conduct of the financial professional. . . or the entity supervising the financial professional.”<sup>4</sup> Fourth, an insurance company must also “[p]rovide to the entity responsible for supervising the financial professional . . . information and reports that are reasonably appropriate to assist such entity to maintain its supervision system.”<sup>5</sup> Finally, an insurance company must distinguish between its obligations under the safe harbor from the situation where it has contracted with a third party for supervision.

### Requirements of the Safe Harbor

One of the most common situations that will generate the use of the safe harbor is the licensed insurance producer who is also registered as a securities agent and is subject to the supervisory control system of a registered securities broker-dealer. Pursuant to the safe harbor, recommendations and sales of annuities made in compliance with business rules, controls and procedures that would satisfy comparable standards<sup>5</sup> are deemed to be compliant with the requirements under the Model Regulation. As an example, a financial professional recommending a variable annuity registered with the United States Securities and Exchange Commission (the “SEC”) under the safe harbor is deemed to comply with the Model Regulation if the securities agent’s broker-dealer has established “business rules, controls and procedures” or a supervisory control system pursuant to FINRA Rules 3110, 3120 and 3130<sup>6</sup> that (1) govern

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- (b) An investment adviser registered under federal [or state] securities laws or an investment adviser representative associated with the federal [or state] registered investment adviser; or
  - (c) A plan fiduciary under Section 3(21) of the Employee Retirement Income Security Act of 1974 (ERISA) or fiduciary under Section 4975(e)(3) of the Internal Revenue Code (IRC) or any amendments or successor statutes thereto.

<sup>4</sup> See Section 6(E)(3)(a).

<sup>5</sup> “Comparable standards” is defined in the Model Regulation in Section 6(E)(5) to mean:

- (a) With respect to broker-dealers and registered representatives of broker-dealers, applicable SEC and FINRA rules pertaining to best interest obligations and supervision of annuity recommendations and sales, including, but not limited to, Regulation Best Interest and any amendments or successor regulations thereto;
- (b) With respect to investment advisers registered under federal [or state] securities laws or investment adviser representatives, the fiduciary duties and all other requirements imposed on such investment advisers or investment adviser representatives by contract or under the Investment Advisers Act of 1940 [or applicable state securities law], including but not limited to, the Form ADV and interpretations; and
- (c) With respect to plan fiduciaries or fiduciaries, means the duties, obligations, prohibitions, and all other requirements attendant to such status under ERISA or the IRC and any amendments or successor statutes thereto.

<sup>6</sup> <https://www.finra.org/finramanual/rules/r3110>; <https://www.finra.org/finramanual/rules/r3120>;  
<https://www.finra.org/finramanual/rules/r3130>

the appropriate recommendation of an SEC registered variable annuity and (2) that satisfies the SEC’s Regulation Best Interest (“Reg BI”).<sup>7</sup>

Making a recommendation in compliance with comparable standards means in compliance with the “business rules, controls and procedures that satisfy a comparable standard...” To avail itself of the safe harbor, the insurance company should review the broker-dealer’s business rules, processes, and procedures that pertain to the firm’s supervisory control system over the registered variable annuities to ensure that they are adequate and that they provide comparable controls as those required under the Model Regulation.

Another common dual license situation involves a licensed insurance agent who is also registered as an investment adviser representative. To avail itself of the safe harbor in this circumstance in a recommendation involving a SEC registered variable annuity, the insurance company should review the business rules, controls, and procedures of the investment adviser to ensure they are adequate and provide comparable controls as those required under the Model Regulation. The fact that an investment adviser by law is a fiduciary and carries potential liabilities for breach of those duties does not in and of itself meet the requirements of the safe harbor. The investment adviser that is in the contractual relationship with the investment adviser representative must have written business rules, controls and procedures that pertain to recommendations of the registered variable annuity that are comparable to the controls that the insurance company would need to directly establish under the Model Regulation but for the safe harbor.

The safe harbor is also available for recommendations of fixed indexed annuities if the insurance company has been able to determine that the securities broker-dealer or investment adviser has established business rules, controls and procedures that were specifically and expressly designed to apply to fixed indexed annuities. As stated in the Model Regulation, an insurance company and insurance producer may avail themselves of the comparable standards safe harbor “even if such standard would not otherwise apply to the product or recommendation at issue.” Even though Reg BI does not apply to insurance products, the safe harbor allows insurance producers who are also regulated under securities laws to operate under those securities business rules, controls, and procedures so long as they are substantially similar to those otherwise required under the Model Regulation. It is important to note that these systems must be adapted to recognize the very significant differences in features and characteristics of fixed index annuities from securities. It would be problematic for an insurance company to allow a broker-dealer

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<sup>7</sup> 17 CFR 240.15l-1 (§ 240.15l-1 Regulation best interest)

agent/insurance producer to recommend its fixed index annuities under the terms of the safe harbor if the broker-dealer's policies and procedures were narrowly designed to address the sale of securities under Reg BI, but do not reference fixed index annuities or consider their particular features and characteristics. Insurers may want to provide guidelines with which the partner must comply as part of the onboarding process to ensure that the entity's processes are adequate.

### **Reasonable Basis**

When analyzing a safe harbor transaction, the model regulation is not proscriptive about how an insurer comes to have a reasonable basis to believe that an annuity would effectively address the particular consumer's financial situation, insurance needs and objectives. That said, given that the rule says that the insurer may base its analysis on information received from the financial professional or the entity supervising the financial professional, it is clear that the rule expects the insurer to conduct an analysis that goes beyond blind adherence to the analysis and conclusions of the entity supervising the financial professional.

What should this analysis consist of? An insurance company must ascertain that a recommendation was made and documented as required by the other comparable standard. The insurer must receive adequate consumer profile information and other evidence of a good faith basis for the transaction to determine that the annuity would effectively address the consumer's financial situation, insurance needs and objectives. In light of this responsibility and its more general underwriting responsibilities, an insurer should receive, review, and retain transactional customer profile and underwriting information. Of course, insurers may not always receive precisely the same data points from the entity supervising the financial professional as it collects on the transactions it directly supervises. The more divergent the data an insurer reviews on safe harbor transactions compared to transactions it directly supervises, the more questions a regulator may have about whether the company is able to comply with Section 6(C)(1) of the Model Regulation on safe harbor transactions.

### **Monitor the Relevant Conduct**

To avail themselves of the safe harbor, insurance companies must monitor the business conduct of the financial professional or the entity supervising the financial professional. As the following aspects of a successful monitoring program will make clear, simply relying on the statement of a financial professional that he or she complied with a comparable standard falls short of the monitoring required of an insurer. Aspects of a successful monitoring program include:

- **Onboarding:** Entering into a new contractual relationship with an entity to sell annuities should involve a review of the entity’s business rules, processes, and procedures to ensure that they are adequate and that they address all the annuities that will be sold under the contractual arrangement. Insurers may want to provide guidelines with which the partner must comply as part of the onboarding process to ensure that the entity’s processes are adequate.

- **Audits:** After onboarding a financial partner, insurers need to ensure that the entity’s policies and procedures remain adequate, and that the entity is doing what it says it will do. This will likely involve creating a strong audit program. Hallmarks of a strong audit program include selecting an adequate sample size, auditing each financial partner frequently enough, and escalation procedures for any financial partner that fails to respond, up to and including termination of the relationship. Selection of audit frequency should be risk-based based on the volume that comes through the channel as well as other risk factors available to the insurer. An appropriate audit program will also ensure that all partners are audited on a regular cycle.

- **Due Diligence Questionnaires:** As a supplement to audits, insurers may use due diligence questionnaires as part of their monitoring of their financial partners. These questionnaires may be stand-alone safe harbor questionnaires or wrapped into a larger vendor due diligence process that could include cybersecurity, state specific requirements, and other issues. Due diligence questionnaires are a stronger form of monitoring than certifications.

- **Ongoing Monitoring:** Due diligence questionnaires are not the only form of ongoing monitoring. Sales data, both aggregated and as segregated by partner, can be categorized, and sorted by number of contracts and by premiums to risk rate producers and partners for key elements such as sales to older consumers, free-look cancellations, early surrenders, replacements, and others.

- **Receiving Data:** Insurers might also request data on an ongoing, perhaps quarterly, basis to aid in their monitoring, including:
  - commissions paid to the producer;
  - number of policies issued;
  - number of replacements issued;
  - number of replacements subject to surrender charges at the prior company;
  - Applications that were turned down due to suitability or other concerns; and
  - Number of consumer complaints related to annuity sales received by the entity supervising the financial professional.

Insurance companies may have some of this data, of course, such as commission paid on an annuity, but the idea of this information sharing is broader than re-sharing individual transaction

data. It is, rather, to ensure that both the insurer and entity supervising the financial professional have the holistic information necessary to make supervision decisions.

### **Provide Information and Reports**

The insurance company must also give information to the entity supervising the financial professional to ensure that that entity has as much information as possible in making supervisory decisions. Information the insurer might share with the supervising entity includes the following:

- Total contracts issued through the producer over the period, including number and type of annuity;
- Amount of commissions paid for each sale to that producer over the period;
- Identify whether the insurer issued any other annuities for the same producer, and if so, how many;
- Identify how many internal replacements were issued by the same producer;
- Number of consumer complaints or lawsuits received by the insurer related to the producer;
- Number of contracts for the producer that were surrendered less than 2 years from policy issue, years 2-5, years 6-10 and more than 10 years from issuance;
- Whether any surrenders were subject to surrender charges.

Insurers may be able to offer partners detailed reports and charts that illustrate customer profile factors for fixed and variable annuities, including issue age, share class, withdrawal charges, rider elections, and free look information.

As mentioned in the last section, the idea of this information sharing requirement is not to duplicate individual transaction data the other party already has. It is, rather, to ensure that both the insurer and entity supervising the financial professional have the holistic information necessary to make supervision decisions.

### **Safe Harbor or Contracting for Performance of Supervision**

The Model Regulation has two different mechanisms in which third parties perform part or all the supervisory process for insurers. They appear superficially similar, but are actually quite different, and it is important that insurers understand under which provision of the Model Regulation they are operating. In addition to the safe harbor, insurers may contract for performance of a part or all its supervisory function pursuant to Section 6(C)(3)(a). Where an

insurer contracts for performance, it must monitor the conduct of the party to whom it outsourced its supervision, including by conducting audits, as appropriate.<sup>8</sup> As a result, these two circumstances seem similar, but they differ in important ways.

In a safe harbor transaction, although the financial professional and the entity supervising the financial professional make the decision that the annuity is in the best interest of the customer, the final responsibility to decide whether an annuity would effectively address the particular consumer’s financial situation, insurance needs and objectives resides with the insurance company. The insurer is almost certainly basing its decision on customer profile information and the basis for the transaction collected by the entity supervising the financial professional, but the safe harbor does not relieve the insurer of its obligation to only issue annuities where 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 consumer’s consumer profile information.”<sup>9</sup> Because of the safe harbor, however, the intent of the disclosure and procedural requirements that are found in the Model Regulation may be achieved by comparable business rules and procedures. For example, a broker-dealer agent would have given Form CRS to his or her client but would not have to give Appendix A to the client when selling an annuity. The onboarding, audits, due diligence questionnaires, contractual policies, and other methods an insurer uses to monitor the entity are to ensure that the entity’s policies, procedures, and implementation of those policies and procedures are truly “comparable” to what is required under the Model Regulation.

On the other hand, where an insurer has contracted for performance, all the provisions of the Model Regulation apply. If the insurer has delegated the entire supervisory process by contract, the entity with which the insurer has contracted for performance would be the one that decides whether the annuity is in the best interest of the consumer on behalf of the insurer. This delegated supervision cannot just be simply transactions-based and must incorporate all aspects of the supervision that the insurer would have incorporated. The insurer must monitor the entity’s conduct, including audits, as appropriate, to ensure that the supervisory system the entity has built “is reasonably designed to achieve the insurer’s and its producers’ compliance with this regulation.”<sup>10</sup> And if the insurer is delegating to an entity that otherwise stands to benefit from the transaction, that potential conflict must be reasonably addressed.

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<sup>8</sup> Section 6(C)(3)(b)(1).

<sup>9</sup> See Section 6(C)(1); see also Section 6(E)(2) (“Nothing in Paragraph (1) shall limit the insurer’s obligation to comply with Section 6(C)(1) of this regulation. . . .”

<sup>10</sup> Section 6(C)(2).