

ANNUITY BEST INTEREST REGULATORY GUIDANCE AND CONSIDERATIONS

SUMMARY

In Spring 2020, the National Association of Insurance Commissioners adopted the *Suitability in Annuity Transactions Model Regulation*, Model 275-1 (“the Model Regulation”). The Model Regulation requires producers to act in the best interest of the consumer when recommending annuities and obligates insurers to establish supervisory systems that ensure recommendations address the consumer’s insurance needs and financial objectives at the time of the transaction.

To account for existing standards applicable to producers also acting as registered representatives, investment adviser representatives, or plan fiduciaries, the Model Regulation includes a safe harbor provision.¹ This provision allows insurance producers to satisfy the Model Regulation’s requirements if they comply with business rules, controls, procedures, and supervisory systems that satisfy a comparable standard, even if the comparable standard does not directly apply to the annuity product or recommendation.

Central to the purpose of the Model Regulation are the insurers’ supervisory duties. The Model Regulation is principles-based, allowing insurers flexibility to design compliance procedures suited to their business. This guidance clarifies supervisory obligations for insurers that issue annuities sold under the safe harbor.

REQUIREMENTS OF THE SAFE HARBOR

To rely on the safe harbor provision, the financial professional must be subject to or apply a comparable standard (as defined in the Model Regulation), and insurers must also meet the following requirements:

1. **Monitoring:** Insurers must monitor the relevant conduct of the financial professionals’ (or entity responsible for supervising the financial professional) using information gathered in the normal course of an insurer’s business.²
2. **Reporting:** Insurers must provide supervising entities (e.g., broker-dealers) with sufficient data for the supervising entity to maintain effective oversight systems.

As discussed further in Monitoring Relevant Conduct – Onboarding below, insurers should also reasonably verify that the safe harbor conditions are satisfied, which can be done when an insurer onboards a supervising entity.

¹ Section 6(E)(1). The prohibited practices in Section 6(D) still apply in safe harbor transactions.

² 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;
- (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. *See* Section 6(E)(3).

DISCUSSION

The safe harbor applies when insurance producers recommending annuities operate under comparable standards, such as those required by the SEC's Regulation Best Interest (Reg BI) and applicable FINRA rules (2330, 3110, 3120, and 3130).³

The safe harbor may be applied if the annuity is a federally registered security and the recommendation is subject to Reg BI and FINRA rules.⁴ However, under appropriate circumstances, the safe harbor may also be applied to fixed annuities (unregistered fixed and fixed indexed annuities). While Reg BI does not directly apply to fixed annuities, the safe harbor ensures insurance producers supervised under securities regulations can use those supervisory control systems if the broker-dealer applies its Reg BI business rules, controls, and procedures to fixed annuities.

INSURERS' 6(C)(1) OBLIGATION

Even under the safe harbor, insurers must comply with Section 6(C)(1) and have a reasonable basis to believe an annuity meets a consumer's financial and insurance needs. This is required whether that annuity is a federally registered security or a fixed annuity. An insurer may contract for performance of this supervisory function pursuant to Section 6(C)(3)(a) so long as it monitors the conduct of the supervising entity, including by conducting audits, as appropriate. An insurer that issues an annuity recommended by a producer relying on the safe harbor and that contractually assigns the 6(C)(1) obligation has to

- 1) "[m]onitor the relevant conduct of . . . the entity responsible for supervising the financial professional," pursuant to Section 6(E)(3) and
- 2) monitor "and, as appropriate, conduct[...] audits to assure the contracted function is properly performed" pursuant to Section 6(C)(3)(b).

The insurer's monitoring program must be constructed with these two similar but distinct monitoring obligations in mind.

SAFE HARBOR USE CASES

The safe harbor may be used in the following situations:

- A licensed insurance producer is also registered as a registered representative and is subject to the supervisory control system of a registered securities broker-dealer.
- A licensed insurance producer who is also an investment adviser representative is subject to a comparable standard.
- A licensed insurance producer, subject to a comparable standard, may make recommendations of annuities not registered with the SEC, such as fixed annuities or fixed indexed annuities.

An insurer's obligation to ascertain the adequacy of the supervising entity's procedures, discussed further below, does not require the insurer to dictate specific policies to the supervising entity.

³ <https://www.finra.org/finramanual/rules/r3110>; <https://www.finra.org/finramanual/rules/r3120>; <https://www.finra.org/finramanual/rules/r3130>; <https://www.finra.org/rules-guidance/rulebooks/finra-rules/2330>

⁴ While most of the examples and information included address a broker-dealer distribution model, a similar analytical framework, with the appropriate flexibility, would apply to an insurance carrier's obligations when entering into a distribution model with investment advisers and plan fiduciaries.

MONITORING RELEVANT CONDUCT

To meet safe harbor requirements, insurers must monitor the insurance producer or their supervising entity. An effective monitoring program involves the insurer taking active steps to assure itself that the supervising entity is complying with its obligations. Simply awaiting complaints or regulatory actions after regulatory exams are passive approaches that are inadequate in and of themselves.⁵ Effective monitoring can include the following:

- **The Contract** – Where the supervising entity is handling the compliance obligations for the insurer, a written contract reduces misunderstanding between the parties as to who is doing the supervising. Contractual provisions may also be used to convey the insurer’s expectations and require the supervising entity to perform contracted responsibilities.
- **Onboarding** – When an insurer onboards a supervising entity, it should review policies and procedures to ensure the compliance arrangement will satisfy the safe harbor through an adequate supervisory system. Insurers should review the policies of the supervising entities to see how they address the unique features of annuity contracts, including their long-term guarantees and surrender charges. An insurer should also review regulatory actions against the supervising entity. For companies that sell both registered and unregistered annuities, one aspect of this inquiry may be to understand if the policies that the broker-dealer or entity developed for the sale of registered annuities also apply to the sale of unregistered annuities (with modest modifications for the product differences). If they do, this is useful evidence on which the insurer may rely.
- **Ongoing monitoring** – To ensure the supervising entity is complying with its obligations, insurers should employ ongoing monitoring, which may include:
 1. Due diligence/compliance questionnaires: these questionnaires may be stand-alone safe harbor questionnaires or wrapped into a larger vendor process that could include cybersecurity, state specific requirements, and other topics.
 2. Periodic engagement: the insurer should periodically engage with the supervising entity’s compliance and/or legal team.
 3. Data analytics: categorize sales data to analyze it from a risk perspective. The categorized data could be sorted by number of contracts and by premiums to get a risk-informed review of producers and broker-dealers or entities for key elements such as sales to older consumers, free-look cancellations, early surrenders, replacements, and others. Reviewing this data may inform the audit program, as discussed below, or may otherwise inform the nature of the due diligence an insurer conducts.
 4. Audits: an effective audit program includes selecting an adequate sample size on a frequent basis and escalation procedures for any supervising entity 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 entity as well as other risk factors available to the insurer. Generally, an insurer should audit a supervising entity with regular frequency. The audit frequency and

⁵ The receipt of a complaint or a supervising entity receiving a regulatory inquiry or action resulting from an exam are risk indicators that require follow-up. Moreover, relying on the lack of regulatory action is insufficient for several reasons, including that an insurer has no way of knowing the status of any regulatory exam and whether that exam focused on annuity sales.

depth will depend on the strength of the other elements of the monitoring program. Post-audit, the insurer should ensure the supervising entity corrects and identifies the root cause of any identified problem.

5. **Registered Annuities:** A regulatory exam that focuses on the supervising entity's annuity sales is strong evidence on which an insurer can rely as part of its monitoring program.
- **Certifications** – Certifications of compliance from the supervising entity are required annually where the partner has assumed the contractual performance of the insurer's 6(C)(1) obligation.⁶ Insurers should also require certifications to cover the entity's compliance with a comparable standard since certifications serve other purposes for insurers. A meaningful certification is detailed and active.

PROVIDING INFORMATION AND REPORTS

Insurers must provide supervising entities with sufficient data to make informed decisions. This may include reports on customer demographics, annuity features, and other relevant factors. Data sharing ensures both parties can oversee transactions effectively without duplicating efforts.

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;
- Number of internal replacements initiated by the same producer;
- Number of contracts issued where the consumer was older than a certain age;
- Number of contracts issued with a death claim pending or complete;
- 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, between years 2-5, between years 6-10, and more than 10 years from issuance; or
- Whether any surrenders were subject to surrender charges.

CONCLUSION

Annuities may not suit all consumers. Insurers are responsible for implementing effective supervisory systems and ensuring compliance with the Model Regulation's best interest requirements. By adhering to these principles, insurers can protect consumers while meeting their regulatory obligations. This guidance emphasizes the active monitoring that must occur for insurers to issue annuities pursuant to the safe harbor.

⁶ 6(C)(3)(b)(ii).