American Council of Life Insurers

Carl B. Wilkerson
Vice President & Chief Counsel, Securities

August 3, 2018

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street N.E.
Washington, D.C. 20549-1090

Re: Proposed Regulation Best Interest ("Reg. BI")[1]

By Electronic Delivery

Dear Mr. Fields:

The American Council of Life Insurers ("ACLI") is a national trade association representing 290 life insurers that hold over 95 percent of the industry's total assets. Our members serve 75 million American families that rely on life insurers' products for financial and retirement security. Our members offer life insurance, annuities, retirement plans, long-term care, disability income insurance, and reinsurance.

ACLI has fully participated in the long-evolving SEC and Congressional dialog about the regulation of broker-dealers and investment advisers.[2] We appreciate the opportunity to share our views on

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[1] Release No. 34-83062 (Apr.18, 2018); File No. S7-07-18; RIN: 3235-AM35; [https://www.sec.gov/rules/proposed/2018/34-83062.pdf] (last visited July 3, 2018); 83 Fed. Reg. 90 (May 8, 2018) at 21754 [https://www.gpo.gov/fdsys/pkg/FR-2018-05-09/pdf/2018-08582.pdf] (last visited July 3, 2018).

[2] Since 2007, ACLI submitted input on four SEC actions concerning broker-dealers and investment adviser standards of conduct, including:

- ACLI's response to the SEC Chairman's Request for Information about Standards of Conduct for Broker-Dealers and Investment Advisers (Oct. 3, 2017) found at https://www.sec.gov/comments/ia-bd-conduct-standards/cll4-2640466-161282.pdf.
- ACLI's July 5, 2013 Submission in response to the SEC's Request *for Data and Information on Brokers, Dealers and Investment Advisers*;
- ACLI's August 30, 2010 Submission in response to the SEC's request for information on its Study *on the Responsibilities of Brokers, Dealers, and Investment* Advisers in fulfillment of Section 913 of the Dodd-Frank Act; and,
- ACLI's December 13, 2007 Submission in response to the *RAND* Study *on Broker-Dealer and Investment Advisory Issues*.

ACLI's RAND Study Submission (and those of other commentators) does not appear to be available on the SEC's website or through RAND. The RAND report included scant, if any, reference to the role life insurance

American Council of Life Insurers
101 Constitution Avenue, NW, Washington, DC 20001-2133
(202) 624-2118 t (866) 953-4096 f carlwilkerson@acli.com
www.acli.com

Reg. BI regarding appropriate conduct standards for broker-dealers. Our submission focuses on this initiative from the perspective of life insurers, their products, their distributors and their customers to ensure the regulation provides an inclusive, business model neutral framework that helps Americans achieve financial and retirement security. We will also offer comments separately on Proposed Form CRS[3] and the SEC's Proposed Interpretation for Investment Adviser Standards of Conduct[4] and its request for input on related questions.

I. Overview of Proposed Regulation Best Interest

Proposed Reg. BI would establish a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. The proposed standard of conduct requires broker-dealers to act in the best interest of the retail customer at the time a recommendation is made without placing the financial or other interest of the broker-dealer or natural person who is an associated person making the recommendation ahead of the interest of the retail customer. This obligation is satisfied under Reg. BI if the broker-dealer:

- Before or at the time of such recommendation reasonably discloses to the retail customer, in writing, the material facts relating to the scope and terms of the relationship, and all material conflicts of interest associated with the recommendation [the disclosure obligation];
- In making the recommendation, exercises reasonable diligence, care, skill, and prudence [the care obligation];
- Establishes, maintains, and enforces written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations [the conflict of interest obligation]; and,
- Establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations [the conflict of interest obligation].

II. The SEC's Objective in Proposed Regulation Best Interest

The narrative accompanying Reg. BI explains the SEC's objectives in Reg. BI are to:

- Enhance the quality of recommendations provided by broker-dealers to retail customers, by establishing under the Exchange Act a ''best interest'' care obligation that encompasses and goes beyond existing broker-dealer suitability obligations under the federal securities laws and that cannot be satisfied through disclosure alone, and further establishing obligations under the Exchange Act that require mitigation, and not just disclosure, of conflicts of interest arising from financial incentives, and thus helps to reduce the potential harm resulting from such conflicts;
- Help retail customers evaluate recommendations received from broker-dealers, as well as address confusion regarding the broker-dealer relationship structure, by improving the

salespersons play in the distribution of IA and BD services. It will be important to include the insurance industry in the analysis on Proposed Regulation BI, Proposed Form CRS, and the SEC's Investment Adviser interpretive analysis and policy questions.

[3] https://www.gpo.gov/fdsys/pkg/FR-2018-05-09/pdf/2018-08583.pdf; (last visited on July 5, 2018).

[4] https://www.gpo.gov/fdsys/pkg/FR-2018-05-09/pdf/2018-08679.pdf; (last visited on July 5, 2018).

disclosure of information regarding broker-dealer conflicts of interest and the material facts relating to scope and terms of the relationship with the retail customer;
- Facilitate more consistent regulation of substantially similar activity, particularly across retirement and non-retirement assets held at broker-dealers, and in this manner help to reduce investor confusion;
- Better align the legal obligations of broker-dealers with investors' reasonable expectations; and,
- Help preserve investor choice and access to affordable investment advice and products that investors currently use.

III. Summary of ACLI's Position

- Reg. BI is a largely sensible, principles-based rule governing broker-dealer conduct. The proposed rule properly implements Section 913 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act").[5] Reg. BI is vastly superior to the prescriptive, and now vacated, DOL Fiduciary Rule and its BIC exemption. Finalization of Reg. BI should retain its neutral approach to business models, operations, compensation and products.
- ACLI is on record that a constructive best interest standard would require financial professionals to put a consumer's interest first by (i) acting with reasonable care, skill, prudence, and diligence in gathering and evaluating information regarding the consumer that is used to make the recommendation; (ii) making no misleading statements; (iii) providing full and fair disclosure of the recommended product's features, fees, and charges; (iv) fairly disclosing how and by whom the financial professional is compensated; and (v) avoiding, disclosing, or otherwise reasonably managing material conflicts of interest.[6] Reg. BI fulfills these objectives.
- The SEC's depth and decades of experience about investment adviser and broker-dealer regulation dovetails with developing a constructive best interest standard that can be uniformly applied across all regulatory platforms, including state insurance regulations. As a result, consumers will enjoy a consistent level of protection and will be able to obtain access to a wide range of retirement products and advice.
- We agree with the Chairman's statement that he SEC "should lead—but not dictate—our federal and state regulatory efforts in this area" to "minimize the effects of regulatory complexity, and potentially inconsistent legal standards applied to financial advice, due to the number of regulators in this space."[7]
- Clarity, consistency and coordination across all regulatory platforms will best serve investors, and thwart regulatory arbitrage.[8] The SEC's inclusive outreach to state regulators and the

[5] Pub.L. 111–203, H.R. 4173 (2010).
[6] *See* ACLI's October 3, 2017 response to Chairman's Request for Information on Standards of Conduct for Investment Advisers and Broker-Dealers at 10 [https://www.sec.gov/comments/ia-bd-conduct-standards/cll4-2640466-161282.pdf]; (last visited on July 5, 2018).
[7] *See* SEC Chairman Clayton's Testimony on Oversight of the U.S. Securities and Exchange Commission (June 21, 2018) [https://www.sec.gov/news/testimony/testimony-oversight-us-securities-and-exchange-commission] before the House Financial Services Committee.
[8] Regulatory arbitrage can occur when financial professionals can choose between varying regulatory standards. Congressional testimony has emphasized the "SEC's attempts to facilitate coordination and limit regulatory arbitrage." *See* https://www.sec.gov/news/testimony/2011/ts061611mls.htm (last visited July 31, 2018). Former SEC Commissioner Elise Walters stated that "The best way to prevent regulatory arbitrage is by

National Association of Insurance Commissioners (NAIC) as partners in the development of a best interest standard is an essential element of effective oversight and regulation.
- Life insurers strongly support protections serving the best interests of customers, which can be meaningfully safeguarded with disclosure about services and material conflicts of interest. This approach provides an effective means to shield consumers and facilitate informed purchase decisions.
- To meet their financial and retirement security needs, retirement savers deserve standards ensuring continued access to a wide variety of retirement products, retirement savings information and related financial guidance from financial professionals acting in their best interest.
- A full assessment about the current regulatory framework is important to the SEC's thorough evaluation of potential approaches under Reg. BI and should include the comprehensive network of state insurance regulation.
- Joint collaborative efforts between the SEC, FINRA, DOL and state insurance regulators will generate a uniform best interest standard across all regulatory platforms that properly protects consumers while advancing financial and retirement security.
- Conscientious evaluation of the many different business models operating in this space and the economic impact of potential modifications will contribute to efficient, effective regulation. Cost-benefit and competitive impact analysis will help achieve this objective.
- Disclosure required under Reg. BI will need careful coordination to properly mesh with amendments to Form CRS. A single disclosure fulfilling Reg. BI and Form CRS would reduce disclosure burdens and increase the likelihood consumers will read the required information.
- The application of Reg. BI's obligations should dovetail with FINRA requirements governing non-cash compensation practices.
- A reasonable implementation period of 18 months following adoption of the SEC initiatives will best enable broker-dealers to implement enterprise-wide compliance and operational practices.

IV. Life Insurers' Interest in Proposed Regulation Best Interest

Life insurers create and market products and services that fulfill consumers' retirement, estate, tax, and financial planning needs[9]. These products and services can implicate the federal securities laws,

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creating clear lines of regulation." *See* https://www.sec.gov/news/speech/2010/spch042310ebw.htm (last visited July 31, 2018).

[9] With the decline of defined benefit pensions and the uncertain health of federal safety net programs like Social Security and Medicare, financial services consumers in the United States bear increasing personal responsibility for their own financial well-being. Life insurers and their broker-dealer affiliates, like other financial services providers, have responded to consumers' needs with a wide range of products and services. These products and services often include:
- term life insurance;
- fixed and variable cash value life insurance;
- disability income insurance;
- long term care insurance;
- many variations of fixed and variable annuity contracts;
- investment brokerage services, including: stocks, bonds, mutual funds, ETF's, and 529 savings plans;

including broker-dealer regulation by the SEC and FINRA under the Securities Exchange Act of 1934, regulation by the SEC under the Investment Advisers Act of 1940, and regulations administered by DOL under the ERISA statute. ACLI has actively participated in the federal securities rulemaking process for over four decades. Life insurers must also satisfy a comprehensive set of state insurance laws and regulations in every U.S. jurisdiction, that are highlighted below in the attached Appendix.

Life insurers also fill a unique and important role in providing financial and retirement services to the less affluent and the middle-income markets that are neglected by other financial service institutions. Life insurance agents serve small towns across the country that are beyond the scope of other financial service providers. This broad geographic and economic outreach enhances American's financial and retirement security.

As institutional investors, life insurers contribute significantly to the U.S. economy and capital formation.[10] In sum, it is critical that proposed Reg. BI equitably includes life insurers' products, functions, services and regulatory framework within the scope of the SEC's focus in developing a final regulation. Some further refinements, discussed below, are necessary to achieve this important objective.

V. The Role of Life Insurers in U.S. Capital Formation and the Economy

The SEC's standard of conduct proposals "were designed to advance the agency's tripartite mission—to protect investors, to maintain fair, orderly and efficient markets, and to facilitate capital formation."[11] The SEC website emphasizes that "the SEC's regulation of the securities markets facilitates capital formation, which helps entrepreneurs start businesses and companies grow. Last year nearly $4.27 trillion was raised in public and private securities offerings, promoting economic growth and job creation."[12] These are important considerations in finalizing a best interest standard for broker-dealers.

Life insurers are significant institutional investors that have a major role in U.S. capital formation and the U.S. economy. Life insurers' assets supporting fixed insurance products ($4.25 trillion) and variable insurance products ($2.52 trillion) reflect a substantial percentage of the U.S. equities and bond market. Life insurers' assets are invested in corporate bonds (33%), stocks (31%), government bonds (8%), commercial mortgages (6%), and other assets (22%). Life insurers are the largest institutional investor in U.S. corporate bond financing. Approximately 48% of life insurers' $7.2 trillion total assets in 2016 were held in long-term bonds, and over 38% of long term bonds purchased by

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- investment advisory services, including: financial planning, fee based wrap accounts, and separately managed accounts;
- individual and business retirement planning;
- estate planning and trust services;
- non-qualified employee benefit consulting; and,
- 401(k) and other qualified plan design, funding and administration.

[10] These important contributions are further explained below in Section V of this submission.

[11] *See* SEC Chairman Clayton's Testimony on Oversight of the U.S. Securities and Exchange Commission (June 21, 2018) [https://www.sec.gov/news/testimony/testimony-oversight-us-securities-and-exchange-commission] before the House Financial Services Committee.

[12] This statement appears on the SEC website highlighting job creation due to capital formation; [http://www.secvip.org/#] (last visited July 3, 2018).

life insurers have maturities exceeding 20 years (at the time of purchase).[13] Life insurers, therefore, are significant participants in the U.S. equities market and are one of the principal sources of U.S. long-term corporate financing. In these roles, life insurers have an important impact on the U.S. economy.[14]

Poorly designed rules can have a significant negative impact on life insurers' capital formation. Before its judicial vacatur, DOL's Fiduciary Rule caused a significant reduction in the sale of new insurance products. Variable annuity sales declined 21 percent in 2016 (from $133 billion in 2015 to $104.7 billion). Further, in the first quarter of 2017, variable annuity sales declined 8 percent, year-over-year, to $24.4 billion, and indexed annuity sales were off 13 percent, to $13.6 billion. [15] Consequently, life insurers had fewer new assets to invest in U.S. capital formation and the economy. The rule also burdened the economic and retirement security of less affluent and middle-income markets distinctively served by life insurers.

The now vacated DOL Fiduciary Rule's profound negative bearing on insurance product sales directly implicated the U.S. economy, capital markets, and capital formation. Valuable lessons spring from these recent experiences. A carefully constructed best interest standard that includes all broker-dealer business models fairly and equitably both protects consumers and enables the continuation of life insurers' contributions to capital formation and the economy.

Several aspects of the SEC's initiatives appear to have been built on the template of full-service broker-dealers that do not fit limited-purpose broker dealers affiliated with life insurers equitably. Section IX below highlights limited purpose broker-dealers affiliated with life insurers and provides an analytical foundation to refine proposed Reg. BI in a business model neutral manner.

In his remarks at the Annual Government-Business Forum on Small Business Capital Formation, SEC Chairman Clayton aptly observed that "a key to restoring vibrancy in our public markets is recognition that a one size regulatory structure does not fit all."[16] We agree.

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[13] These calculations are based on data from the 2017 NAIC Annual Statement Data and ACLI calculations based on the U.S. Federal Reserve Board, Flow of Funds Accounts of the U.S.

[14] We greatly appreciate the Chairman Clayton's recognition of life insurers contributions to U.S. capital formation and the economy. *See* SEC Chairman Clayton's Testimony on Oversight of the U.S. Securities and Exchange Commission (June 21, 2018) [https://www.sec.gov/news/testimony/testimony-oversight-us-securities-and-exchange-commission] before the House Financial Services Committee. The Chairman's testimony noted that at least 51% of U.S. households are invested directly or indirectly in our capital markets with 44% of all households owning at least one U.S. mutual fund. It is also important to note that like mutual funds, many U.S. households also participate indirectly in our capital markets through variable annuities and variable life insurance contracts funded by an array of underlying mutual funds: 29,172,000 individual variable annuity contracts and 4,959,000 individual variable life insurance contracts were in force in the U.S. as of 2016. Many Americans indirectly participate in the U.S. stock market through these SEC regulated contracts.

[15] The damage inflicted on annuity sales also caused an adverse ripple effect on the contributions of agents and distributors to the economy, tax revenue and small business employment.

[16] *See Remarks to the Annual Government-Business Forum on Small Business Capital Formation* (Nov. 30, 2017); [https://www.sec.gov/news/public-statement/annual-government-business-forum-small-business-capital-formation] (last visited on July 3, 2018).

VI. The Importance of Statements in the SEC Narrative Explaining Reg. BI

As noted above, the text of Reg. BI provides a largely sensible, principles-based rule governing broker-dealer conduct that properly implements Section 913 of the Dodd–Frank Act and is vastly superior to the proscriptive (and now vacated) DOL Fiduciary Rule and its BIC exemption. The SEC's narrative explaining Reg. BI adds important details about the rule's purpose, the SEC's intent and standards of compliance. We offer comment below on aspects of the narrative that are significant for life insurers, their products, their distributors, and their customers. It will be important to reiterate the interpretative nuances provided in the narrative noted below in the final rule's release to establish equitable and clear guidance.

A. General Objectives of Proposed Regulation Best Interest[17]

The release indicates that the SEC sought to "preserve—to the extent possible—investor choice and access to existing products, services, service providers, and payment options."[18] The SEC expressed sensitivity to "to the potential risk that any additional regulatory burdens may cause investors to lose choice and access to products, services, service providers, and payment options."[19] ACLI strongly endorses these important SEC goals. Reg. BI is largely product neutral and properly avoids creating classes of regulatory winners and losers. As such, Reg. BI constructively ensures investor choice and access to existing products, services, service providers, and payment options. Our discussion below at Section XII explains how investor choice and access to a wide range of products, services and compensation arrangements will help Americans achieve financial and retirement security.

In the proposal the SEC "sought to avoid a lack of clarity or consistency in the applicable standards and a lack of coordination among regulators, which could ultimately undermine investor choice and access and create legal uncertainty in developing effective compliance programs."[20] We applaud and encourage the SEC's endeavors to clearly establish the elements of a broker-dealer best interest standard and the commendable outreach and coordination with state insurance regulators, FINRA and other federal regulators.[21] Regulatory consistency across all regulatory platforms will best serve consumers and avoid harmful regulatory arbitrage. Our discussion below at Sections X, XI and the attached Appendix summarizes current state insurance parallels to FINRA suitability and best interest developments that should provide constructive state-federal consistency.

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[17] This category of discussion begins at page 21583 of the Reg. BI release.

[18] Reg. BI Release at 21583. This fully parallels positions in the U.S. Department of the Treasury report *A Financial system that Creates Economic Opportunities-Asset Management and Insurance* (Oct. 2017) https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf (last viewed Aug. 2, 2018) ["Treasury Report"]. The Treasury report states that "Treasury believes that conflicts of interest should be addressed in a manner that preserves, to the extent possible, access to a wide range of asset classes, investment products, business models, distribution channels, and other relevant features of financial services that benefit American workers and their families." *Id.* at 69.

[19] *Id.*

[20] Reg. BI Release at 21583.

[21] The Treasury Report explains "Treasury believes that conflicts of interest should be addressed in a manner that does not disrupt the free functioning of the markets and access to financial services." Treasury Report at 69.

In Reg. BI, the SEC appropriately "sought to preserve the ability of investors to pay for advice in the form of brokerage commissions" in response to "commenters' observations that the commission-based model may be more appropriate for many investors" and "that such investors may prefer a commission-based brokerage over a fee-based account."[22] Life insurers strongly support the SEC's determination to preserve consumers' access to both commissioned and fee-based forms of compensation. This approach flexibly permits consumers to choose the most appropriate compensation method, while also establishing a business model neutral regulatory framework. Our discussion below at Section VIII explains further the sound rationale for different compensation models.

The SEC's narrative explains that Reg. BI "builds upon, and is tailored to, existing broker-dealer relationships and regulatory obligations under the federal securities laws and SRO rules. In particular, the existing rules of various SROs served as an important point of reference for" Reg. BI.[23] The SEC's prudent recognition of existing rigorous obligations under SRO rules, the federal securities laws and state insurance laws buttresses the effectiveness of Reg. BI and avoids the layering of duplicate or conflicting standards. [24] For example, FINRA's comprehensive variable contract suitability, supervision and non-cash compensation rules dovetail perfectly with the purpose and intent of Reg. BI. The implications of these rules and their significant consumer protection are discussed in greater detail below at Section XI and in the Appendix.

The release explains that Reg. BI "would help preserve investor choice and access to affordable investment advice and products that investors currently use."[25] Multiple government studies and news reports have underscored financial and retirement challenges confronting Americans. Continued access to a broad range of products and advice constructively allows Americans of all strata to design and achieve financial and retirement security. Other (now vacated) regulatory approaches that limited choice and access inappropriately substituted governmental judgment for consumer choice and marketplace competition.

According to the SEC's narrative, "Regulation Best Interest would only apply when a broker-dealer is making a recommendation to a retail customer about a securities transaction or an investment strategy involving securities." "The regulation would not apply to the provision of services that do not involve or are distinct from such a recommendation."[26] Life insurers fully support this purpose and intent in Reg. BI, which properly implements Section 913 of the Dodd-Frank Act. Tailoring the scope of Reg. BI to broker-dealer recommendations about securities in the retail market is an appropriate application of the federal securities laws and the SEC's interpretations thereunder.

[22] Reg. BI Release at 21584.

[23] *Id.*

[24] The Treasury Report, *supra* note 18, emphasizes that "[f]inancial professionals involved in securities are already extensively regulated and examined by the SEC and state securities regulators and, in the case of broker-dealers, by FINRA. Treasury Report at 69. The Treasury Report further emphasized that "[f]inancial professionals, including those advising on securities investments in IRA accounts, have been long subject to rules under federal and state securities laws that impose standards of conduct designed to protect retail investors." *Id.* at 66.

[25] *Id.*

[26] *Id.*

The Reg. BI narrative emphasizes that "Regulation Best Interest applies in addition to any obligations under the Exchange Act, along with any rules the Commission may adopt thereunder, and any other applicable provisions of the federal securities laws and related rules and regulations. "Proposed Regulation Best Interest would not create any new private right of action or right of rescission," nor did the SEC "intend such a result."[27] Life insurers strongly concur with the SEC's clear statement that Reg. BI does not create private rights of action or rescission rights. This policy properly reflects the statutory foundation of the Exchange Act as it applies to recommendations to retail customers about the purchase of a security, in contrast with the judicially created fiduciary duty governing activity under the Investment Advisers Act.

The SEC explained that "we wish to underscore that proposed Regulation Best Interest focuses on specific enhancements to the broker-dealer regulatory regime, in light of the unique characteristics of the brokerage advice relationship and associated services that may be provided, and therefore would be separate and distinct from the fiduciary duty that has developed under the Advisers Act."[28] Again, life insurers strongly agree with the SEC's unequivocal emphasis that Reg. BI involves refinements to the broker-dealer regulatory framework governing a transactional brokerage advice arrangement, and is separate and distinguishable from the judicially interpreted fiduciary duty under the Advisers Act.

B. Overview of Regulation Best Interest

The Reg. BI narrative notes that "[i]n particular, as a threshold matter, it is worth noting that, in determining how to frame the proposed best interest obligation, we considered the 'best interest' standards outlined in other contexts, in particular the standard set forth in Section 913(g) of the Dodd-Frank Act and the 913 Study recommendation, as well as the DOL's 'best interest' Impartial Conduct Standard, even though we are not proposing a uniform fiduciary standard under Section 913(g)."

Significantly, the narrative goes on to emphasize that "[o]ur proposed definition differs from the wording of these standards by replacing the phrase 'without regard to the financial or other interest' with the phrase 'without placing the financial or other interest . . . ahead of the interest of the retail customer.' We are proposing this change as we are concerned that inclusion of the 'without regard to' language could be inappropriately construed to require a broker-dealer to eliminate all of its conflicts (i.e., require recommendations that are conflict free), and we believe that our proposed formulation appropriately reflects what we believe is the underlying intent of the 'without regard to' formulation.

Importantly, the SEC underscores "that, like other investment firms, broker-dealers have conflicts of interest, in particular financial interests, when recommending transactions to retail customers. Certain conflicts of interest are inherent in any principal-agent relationship. We do not intend for our standard to prohibit a broker-dealer from having conflicts when making a recommendation. Nor do we believe that is the intent behind the 'without regard to' phrase, as included in Section 913 of the Dodd- Frank Act or recommended in the 913 Study, as is evident both from other provisions of Section 913 that

[27] *Id.*
[28] Reg. BI Release at 21585.

acknowledge and permit the existence of financial interests under that standard, and how our staff articulated the recommended uniform fiduciary standard."[29]

Life insurers strongly endorse the SEC's determination to replace the phrase ''without regard to the financial or other interest'' with the phrase ''without placing the financial or other interest . . . ahead of the interest of the retail customer'' in the obligation under Reg. BI. This improved language avoids confusion and awkward applications. Indeed, the "without regard to" provision could have been interpreted to imply that if a broker-dealer obtained any commission in any amount, it violated the best interest standard. The SEC's determination constructively clarifies that broker-dealers' compensation for their services would not presumptively conflict with Reg. BI.

In a related vein, the Release correctly states that "among other things, Dodd- Frank Act Section 913(g) expressly provides that the receipt of commission-based compensation, or other standard compensation, for the sale of securities shall not, in and of itself, violate any uniform standard promulgated under that subsection's authority as applied to a broker-dealer."[30] Life insures fully agree.

Importantly, the release explains that "Dodd-Frank Act Section 913 provides that offering only proprietary products by a broker-dealer shall not, in and of itself, violate such a uniform fiduciary standard, but may be subject to disclosure and consent requirements."[31] This reaffirmation of Section 913's treatment of proprietary products properly reflects Congressional intent and allows consumers to obtain appropriately recommended proprietary products, with appropriate conditions, that buttress Americans financial and retirement security.

"The best interest obligation would not extend beyond a particular recommendation or generally require a broker-dealer to have a continuing duty to a retail customer."[32] Life insurers fully support this important clarification. The statement should be affirmatively restated in the preamble or release supporting the final Reg. BI adoption.

The release explains that the 913 Study recommended uniform standard would neither require the absolute elimination of any particular conflicts (in the absence of another requirement to do so) nor impose on broker-dealers a continuing duty of loyalty or care."[33] Life insurers strongly support this significant clarification about the application of Reg. BI and its reaffirmation of the Section 913 Study. The preamble or the release supporting the final Reg. BI adoption should affirmatively restate this important statement

[29] Reg. BI Release at 21586. Importantly, the SEC's approach embellishes the view in the Treasury Report, note 18 *supra,* that " conflicts of interest should be addressed in a manner that preserves, to the extent possible, access to a wide range of asset classes, investment products, business models, distribution channels, and other relevant features of financial services that benefit American workers and their families."

[30] *Id.*

[31] *Id.*

[32] Reg. BI Release at 21617.

[33] Reg. BI Release at 21590.

C. Definition of Best Interest

The SEC highlights that "[w]e are not proposing to define 'best interest' at this time. Instead, we preliminarily believe that whether a broker-dealer acted in the best interest of the retail customer when making a recommendation will turn on the facts and circumstances of the recommendation and the particular retail customer, along with the facts and circumstances of how the four specific components of Regulation Best Interest are satisfied."[34] Life insurers support an implementation of Reg. BI that considers unique customer factors and the application of the four components of the proposed regulation.

The Reg. BI narrative observes that "[t]his proposal is not meant to effectively eliminate recommendations that encourage diversity in a retail customer's portfolio through investment in a wide range of products, such as actively managed mutual funds, variable annuities, and structured products. We recognize that these and other products that may involve higher risks or cost to the retail customer may be suitable under existing broker-dealer obligations. We believe these products could likewise continue to be recommended under Regulation Best Interest if the broker-dealer satisfied its obligations under proposed Regulation Best Interest."[35] This correct and important clarification serves consumers well by preserving and valuing choice through access to a broad range of products and services. It is a sound regulatory conclusion that should be restated in the adoption preamble or release.

The narrative notes that "[s]pecifically, as further clarification, proposed Regulation Best Interest would not *per se* prohibit a broker-dealer from transactions involving conflicts of interest, such as the following:

- Charging commissions or other transaction-based fees;
- Receiving or providing differential compensation based on the product sold;
- Receiving third-party compensation; or,
- Recommending proprietary products, products of affiliates or a limited range of products."[36]

The SEC further clarifies that "[t]hese practices, which generally involve conflicts of interest between the broker-dealer and the retail customer, would be permissible under Regulation Best Interest only to the extent that the broker-dealer satisfies the specific requirements of Regulation Best Interest."[37] Life insurers support these mechanics for fulfilling the regulation. Denoting arrangements that are not *per se* prohibited allows consumers to participate in the full universe of products and services available from broker-dealers while enjoying the worthwhile protections built into Reg. BI's disclosure obligation, care obligation, and conflict of interest obligation.

In further clarification, the SEC explains that "to satisfy proposed Regulation Best Interest, a broker-dealer would not be required to analyze all possible securities, other products or investment strategies to find the single 'best' security or investment strategy for the retail customer, broker-dealers generally should consider reasonably available alternatives offered by the broker-dealer as part of having a

[34] Reg. BI Release at 21587.
[35] *Id.*
[36] *Id.*
[37] *Id.*

reasonable basis for making the recommendation, as required under the Care Obligation."[38] Life insurers strongly support the SEC's explanation and rationale here. Requiring analysis of all possible securities or strategies to find the "best" recommendation would be unavailing and impossible. Requiring review of "reasonable alternatives" offered by the broker-dealer makes practical and functional sense.

The SEC's narrative explains that "proposed Regulation Best Interest also would not necessarily obligate a broker-dealer to recommend the 'least expensive' or the 'least remunerative' security or investment strategy, provided the broker-dealer complies with the Disclosure, Care, and the Conflict of Interest Obligations."[39] We agree completely. Insistence on the least expensive or least remunerative choices could ironically undermine the best interest of consumers. These clarifications comport fully with the mandates in Section 913 of the Dodd-Frank Act and should be restated in the release adopting a final Reg. BI.

VII. Selected Items for Refinement or Clarification in Reg. BI

We recommend that several items in proposed Reg. BI be refined and revised. These changes will enhance the proposed rule's purpose and application, while achieving a clear and equitable focus.

A. Coordination of Disclosure under Reg. BI and Form CRS

The disclosure obligation under Reg. BI provides an important means for consumers to understand the material facts relating to the scope and terms of the relationship, and all material conflicts of interest associated with the recommendation. The SEC's approach here properly advances informed consumer decision making, and equitably allows broker-dealers to create disclosure tailored to their specific business model, product line, and operation. This framework wisely avoids a "one-size-fits-all" approach to regulation recently noted by SEC Chairman Clayton.[40]

The disclosure standards in Form CRS, however, do not mesh well with the disclosure proposed in Reg. BI. Further, the creation of two new disclosure events may frustrate the worthwhile goals of consumer understanding by enlarging the already significant number of disclosure documents a consumer would face.[41] The volume of disclosure currently delivered can, unfortunately, dilute the value of meaningful disclosure essential to understanding and informed decision making. Increased disclosure documents also thwart the SEC's commendable emphasis on streamlined, simplified, user-friendly, plain-English information.[42] A single disclosure fulfilling Reg. BI and Form CRS would reduce disclosure burdens and increase the likelihood consumers will read the required information.

[38] Reg. BI Release at 21587.
[39] Reg. BI Release at 21588.
[40] Chairman Clayton observed that "a key to restoring vibrancy in our public markets is recognition that a one size regulatory structure does not fit all." *See Remarks to the Annual Government-Business Forum on Small Business Capital Formation* (Nov. 30, 2017); [https://www.sec.gov/news/public-statement/annual-government-business-forum-small-business-capital-formation] (last visited on July 3, 2018).
[41] For the variable life and variable annuities under the SEC's jurisdiction this can be especially profound. Consumers will already receive a prospectus, a contract under state insurance law, sales literature, confirmation statements, periodic reporting documents and other related disclosures.
[42] The disclosure burdens on variable annuity consumers could be further reduced if the SEC implemented long evolving simplified variable product prospectus disclosure and FINRA point-of-sale disclosure.

We encourage the SEC to clarify that broker-dealers can appropriately elect to merge required disclosure under Reg. BI and Form CRS in a single document.

The disclosure under Reg. BI and Form CRS should fulfill parallel philosophies and avoid conflicting or confusing consumer information. Suggested conforming changes are discussed in greater detail in our comment letter on Form CRS, which notes that, among other things, that the proposed form:

- Is built on the template of a full-service broker-dealer and fits limited purpose broker-dealers or investment advisers affiliated with life insurers poorly;
- Stipulates a length that may be too short for broker-dealer or investment adviser information in the insurance world;
- Is overly prescriptive, in contrast with the appropriate custom tailoring for disclosure under Reg. BI;
- Imposes an inappropriate competitive imbalance and inaccurate picture concerning the relative number of disciplinary actions in sales organizations with large numbers of financial professionals;
- Establishes unnecessarily restrictive formatting standards for dual (broker-dealer/investment adviser) registrants;
- Is not flexible enough to fully describe in a meaningful and accurate way investment advisory services provided by insurance affiliates that are not registered investment advisers, such as banks or thrifts;
- Requires statements that are inapplicable, inaccurate or misleading; and,
- Establishes conflict of interest disclosure unsynchronized with that in Reg. BI.

The disclosure standards and objectives should be consistent and parallel in Form CRS and Reg. BI to avoid confusion and to promote clear understanding. A more flexible approach to required disclosure is preferable and would serve consumers better.

Another practical approach to communicating useful information without dilution through over-disclosure would allow elective access to more detailed disclosure through imbedded links to broker-dealer or product manufacturer websites, where consumers can find more comprehensive information.[43] The SEC has referenced and supported this constructive approach in Reg. BI and other initiatives.

[43] We would urge that consideration of any additional disclosure requirements would include a thorough analysis of the disclosures that retail customers currently receive. For example, when purchasing a deferred variable annuity, a retail (and other) customer must be informed of the general terms of various features of deferred variable annuities, such as surrender period and surrender charges; potential tax penalties; mortality and expense charges; investment advisory fees; potential charges for and features of riders; the insurance and investment components; and market risk. Additionally, such retail (and other) customers must be provided with a product prospectus, which provides a comprehensive and detailed description of the variable annuity. Finally, such retail (and other) customers are provided prospectuses for the mutual funds underlying the product subaccounts in which they invest. Simply piling more disclosure on top of the above-noted disclosure information is more likely to result in "information overload" than an enhanced understanding of the product or transaction by retail customers.

This position is consistent with current SEC statements, in particular those made at the time of the recent amendments to the Form ADV Part 2.[44] The SEC stated in the adopting release that it "will continue to consider different approaches to delivering financial information to investors."[45] The SEC should consider approaches that enable BDs and IAs provide concise and helpful written disclosures to retail customers, by allowing BDs and IAs to reference links to their websites for certain types of additional, detailed information. It should be reconfirmed in the final Reg BI adoption.

B. Treatment of Conflicts of Interest

Under Reg. BI, non-financial potential conflicts of interest require disclosure. In contrast, potential conflicts associated with financial incentives require mitigation *and* disclosure or elimination, which may be confusing to differentiate and implement within compliance regimes. In response to this concern, ACLI's members developed a consensus that "mitigate" should be dropped from the regulation and financial incentive conflicts should be treated like any other. If the mitigation element remains in the regulation, the distinction between mitigation and elimination of conflicts of interest needs to be clarified. Further, more SEC guidance is necessary about how broker-dealers can demonstrate mitigation of conflicts of interest. Clarification on the meaning of "mitigate" would be constructive. There may also be an unintended but inapt imbalance in the initiative's overall regulatory framework because broker-dealers will have to disclose, mitigate or eliminate conflicts while investment advisers will only have to disclose them.

Clarification on the scope of broker-dealer conflict management and mitigation under Reg. BI can be constructively drawn from the comprehensive *FINRA Report on Conflicts of Interest*.[46] In its conflicts report FINRA focused on broker-dealers' approaches to identifying and managing conflicts in three critical areas—broker-dealers':

- Enterprise-level frameworks to identify and manage conflicts of interest;
- Approaches to handling conflicts of interest in manufacturing and distributing new financial products; and,
- Approaches to compensating salespersons.

The report identified effective practices that FINRA observed or that, based on experience and analysis, FINRA believed could help broker-dealers improve their conflicts management practices. It also contained more general observations and commentary on firms' practices for enhanced conflicts management.[47] The report encouraged the creation of a comprehensive framework to identify and manage conflicts of interest across and within broker-dealers' business lines that is scaled to the size and complexity of their business.

The FINRA conflicts report provides a valuable guidepost to conflicts management and mitigation. Currently the FINRA report is advisory in nature. The SEC should consider the value of

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[44] Amendments to Form ADV, Investment Advisers Act Release No. IA-3060 (July 28, 2010), *available at* http://www.sec.gov/rules/final/2010/ia-3060.pdf (last visited on July 31, 2018).

[45] *Id.*

[46] https://www.finra.org/sites/default/files/Industry/p359971.pdf (last visited on July 31, 2018). The FINRA conflicts report was published in October 2017.

[47] FINRA recognized that the effective practices and observations in its report are drawn from discussions with large broker-dealers and, as a result, will not in all cases be directly applicable to smaller broker-dealers.

recommending that FINRA codify the substance of the report in a formal rule after circulation to and input from interested parties, followed by SEC approval.

C. Waiver of Requirements When Customers Decline to Provide Information

It may be challenging to demonstrate compliance with Regulation BI's permissive waiver when the customer refuses to provide information essential to best interest determinations. While the waiver is a sensible approach that parallels FINRA's treatment of suitability obligations when customers refuse to provide information essential to execution of the suitability process, Reg. BI leaves unstated how broker-dealers should appropriately demonstrate compliance with the customer refusal waiver in Reg. BI under these circumstances. Further SEC clarification on this point would enhance the application of and compliance with Reg. BI.

VIII. Forms of Compensation in the Delivery of Financial Services and Information

Compensation in the delivery of financial advice and products has evolved to include different business models and to utilize advances in technology. These market-based developments provide a wide range of choice for both consumers and advisers. Regulation of compensation practices, however, should be unbiased and permit a broad spectrum of compensation arrangements. Reg. BI achieves this commendable objective.

Financial product recommendations and associated compensation arrangements are most objectively evaluated according to the unique facts and needs of each financial client and the individual compensation arrangement. Financial advisers who obtain their compensation through annual fees based on assets under management ("wrap fees") would be less likely to recommend certain commission-based products, like annuities, because that purchase is not generally included within the assets under management on which the annual, recurrent fees are assessed by this type of fee-based financial adviser. Recurrent annual fees may be ill-suited to individuals with moderate assets needing little annual advice and may exceed the total value of a commissioned-based financial adviser. Reg. BI appropriately does not elevate one form of compensation over others, in contrast with the now vacated DOL Fiduciary Rule.

By way of background, FINRA issued guidance about fee-based arrangements, recognizing that while fee-based programs are beneficial for some customers, "they are not appropriate in all circumstances."[48] FINRA instructs that:

> Firms must consider the overall needs and objectives of the customer when determining the benefits of a fee-based account for that customer, including the anticipated level of trading activity in the account and non-price factors such as the importance that a customer places on aligning his or her interests with the broker. Additionally, firms must take into account the nature of the

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[48] *See* Notice to Members 03-68, *Fee-Based Compensation-NASD Reminds Members That Fee-Based Compensation Programs Must Be Appropriate*, http://www.finra.org/sites/default/files/NoticeDocument/p003079.pdf (last visited on July 31, 2018).

> services provided, the benefits of other available fee structures, and the customer's fee structure preferences.[49]

As FINRA aptly observes, under some customer circumstances, compensation through commission arrangements may be more appropriate than fee-based arrangements. Quite correctly, FINRA explained that the appropriateness of fee-only financial arrangements should be evaluated on the unique circumstances of each customer and their financial needs. The same is true with evaluations of commissioned recommendations to purchase certain financial products like annuities.[50] There are many customers for whom annuities provide a valuable and appropriate means to achieving retirement security and guaranteed lifetime income.

The fact that the salesperson was compensated by commissions does not diminish the important role annuities play in financial and retirement security. Commission-based compensation can be the most economical and appropriate form of compensation in advisory arrangements with consumers owning moderate amounts of retirement assets and may be significantly less expensive than non-commissioned forms of compensation, such as asset management fees.

The now vacated Fiduciary Rule inappropriately elevated fee-based advice and automated robo-advice systems as preferable alternatives because they were perceived as cheaper and thus better aligned with the interests of retirement plan participants. These premises were incorrect in many cases. Recommendations under such philosophies that concentrate on the least expensive product may actually disserve and impair the participant's best interests. While fee-based or automated advice are appropriate for some individuals, they are not necessarily appropriate for all. The SEC's approach in Reg BI properly recognizes and permits different compensation arrangements that appropriately serve needs of consumers and "preserve investor choice and access to affordable investment advice and products.[51]" Reg. BI should continue to allow the broad range of compensation models without bias for or against any one approach. Disclosure is an important adjunct to helping consumers understand different compensation arrangements.

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[49] *See Fee-Based Questions and Answers*, http://www.finra.org/industry/fee-based-account-questions-answers (last visited on July 31, 2018).
FINRA stated that

> Certain potential problems have been identified through our examination program. For example, it is not always clear that customers receive adequate disclosure about the distinctions and features of fee-based versus commission-based accounts, including the differences in fee structures and that fees will probably be higher in a fee-based account if the level of activity is modest. Training and education at some firms are minimal, particularly in giving brokers guidance on how to evaluate whether a customer is appropriate for a fee-based account.

[50] Elisse B. Walter, who served as acting SEC chair, SEC Commissioner, and FINRA Senior Executive Vice President, noted:

> In a nutshell, while fee based accounts can be a good thing, they are not always the right thing, or the best thing. We need you to look at each customer and determine what kind of fee works best for him or her. The Tully Report itself recognized that investors with low trading activity would probably be better off with a commission-based program that charges only when trades are made. *See* Elisse Walter, *Current NASD Regulatory Issues on Sales and Marketing* (Sept. 28, 2004) http://www.finra.org/newsroom/speeches/092804-remarks-27th-annual-sia-sales-and-marketing-conference (last visited on July 31, 2018).

[51] Reg. BI Release at 21583.

IX. The Operation and Scope of Business Conducted by Broker-Dealers Affiliated with Life Insurers

A brief background on the nature of operations, services and securities products associated with life insurers may help frame our concern with several aspects of Reg. BI and may help transform the regulation into a more equitable framework. Generally, broker-dealers affiliated with life insurance companies are significantly different from full service or “wire-house” broker-dealers in their operations, products and services.[52] One type of broker-dealer affiliated with life insurers engages in retail securities activities primarily, or only, in the context of a larger insurance business. Many registered representatives associated with these broker-dealers operate principally as life insurance and annuity salespersons. Securities sales can frequently constitute an incidental amount of business (or none) relative to variable insurance product sales by an office or registered representative. Some of these broker-dealers sell only the products of their affiliated life insurance company.

In some cases, the insurance-affiliated retail broker-dealer may sell a broader array of securities products, including mutual funds, 529 plans, 401(k), 403(b) plans and individual securities. Certain of these broker-dealers and a segment of their registered representatives are dually registered as investment advisers and investment advisory representatives (“IAR” or “IARs”), respectively, and can also offer various investment advisory services such as financial planning for a fee and managed accounts. As a by-product of this type of broker-dealer affiliated with life insurers, supervision and compliance is often conducted within the overall insurance distribution system, and fulfills FINRA, SEC and state insurance standards.

Another type of life insurer-affiliated broker-dealer is strictly a “wholesaler” distributing the insurance company’s variable products through affiliated and unaffiliated selling broker-dealers. This type of broker-dealer generally does not engage in retail activities and does not maintain possession or control of customer funds or securities. Those insurance company employees who perform wholesaling duties or certain related activities are generally registered with the insurer’s wholesaling broker-dealer. Care should be taken in Reg. BI to distinguish these types of wholesaling broker-dealer activity from widespread retail sales broker-dealer activity. In some instances, an insurance-affiliated broker-dealer may conduct both wholesaling and retail activity.

For decades life insurers have used non-cash compensation, such as educational conferences and other tangible non-monetary rewards, to motivate and train their agents without compromising the suitability of sales. Reg. BI discussed financial incentives and practices and asked whether non-cash compensation should be limited.[53]

Non-cash compensation associated with products subject to SEC jurisdiction (variable annuities and variable life insurance) are strictly regulated under FINRA rules that successfully proscribe abusive practices, as explained below. Reg. BI should not change the ability of life insurers to conduct business that fulfills FINRA non-cash compensation standards.

Reg. BI should not burden or preclude the operation of compensation arrangements and business models, including non-cash compensation arrangements, such as producer meetings that are educational or that reward production. Disclosure about compensation arrangements and structures is appropriate and superior to limiting different business models.

[52] Some full-service broker-dealers may sell variable annuities and variable life insurance.

[53] *See* Reg. BI Release at 21621 and 21624.

SEC action on Reg. BI should not prioritize one form of compensation over other forms of compensation. For example, graduated compensation should not be preferred over others, such as non-cash compensation. It is important to differentiate that FINRA Rule 2320 defines non-cash compensation more broadly than simply “sales contests,” as referenced in the Reg. BI Release. Excessively broad bans on non-cash compensation could contradict FINRA Rule 2320 and unnecessarily disrupt the programs it allows.

The SEC should not constrict the method of compensation as a general matter, because it puts the SEC in the inappropriate position of picking and choosing among different compensation models in the marketplace. Instead, any SEC action should be neutral toward compensations systems, and emphasize disclosure about potential conflicts of interest. In large measure, Reg. Bi achieves this.

As explained further in the Appendix and Section X, FINRA carefully developed Rule 2320 which strictly limits non-cash compensation arrangements and Rules 2330 which imposes granular variable product suitability standards, following extensive and comprehensive rulemaking initiatives that were approved by the SEC.[54] Reg. BI should allow FINRA compliant non-cash compensation programs. FINRA’s enhanced variable contract suitability rule together with its non-cash compensation restrictions provide rigorous consumer protections, and safeguard against conflicts of interest.

Reg. BI should not prohibit carefully regulated non-cash compensation practices, including those based on production. We provide background and discussion below about the role and regulatory status of non-cash compensation arrangements in the life insurance industry. Life insurers support regulatory enhancements that facilitate a broker-dealer’s ability to execute compliance and supervision responsibilities in securities-related activities of their associated persons. Non-cash compensation is strictly regulated under FINRA rules that protect the sales process and has existed in the life insurance industry for many decades. Elimination of non-cash compensation would inflict a disruptive economic impact. Any prohibition of non-cash compensation would be unwarranted.

(A) Non-Cash Compensation in the Life Insurance Industry

Traditionally, life insurance companies have offered tangible non-cash incentives to reward and encourage sales efforts in the distribution of insurance products. Life insurance companies award their salespersons "production credits" for insurance sales which are applied to non-cash incentive programs. In conducting sales incentive programs within the company, some insurers also award production credits for the sale of securities to their agents who are registered representatives of its affiliated insurance broker-dealer. Typically, the company awards production credits to encourage and recognize the sale of variable products or mutual funds its sponsors.[55]

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[54] The narrative specifically acknowledged FINRA rules that govern and limit non-cash compensation. *See* Reg. BI Release at 21577, footnote 12.

[55] Under some general agency arrangements, individual insurance agents contract directly with the general agent and not the life insurance company itself. In turn, some general agencies may offer non-cash production incentives which are independent from the life insurance Company. Significantly, however, productions incentives offered by general agents are not financed by product sponsors like insurance company non-cash sales incentives, therefore, these programs do not reflect the influence of outside product sponsors for the reasons discussed in the text, therefore, general agency incentive programs do not trigger the unstated hypothetical concerns reflected in the Reg. BI narrative.

In limited circumstances, some insurers also grant credit for the sale of other companies' products, which may include variable contracts or mutual funds. In these situations, however, the outside product sponsor does not provide or finance non-cash incentives. As with its own products, the life insurer establishes any incentive arrangements. Non-cash sales incentive programs in the life insurance industry serve worthwhile training and educational goals that help salespersons better serve consumers.

ACLI member companies use a variety of non-cash compensation arrangements to reward and incentivize their salespersons. These arrangements include, among other things, sales conferences and related events; trophies, ribbons, plaques and other awards; and advanced training, technology and marketing assistance. These non-cash arrangements provide certain important business benefits that cash compensation cannot provide.

Similarly, non-cash compensation that takes the form of sales or educational conferences provides further benefits like allowing salespeople to gather together and share their experiences and learn from each other and learn more about the products and services that they can offer. It is important to balanced and equitable regulation to avoid unnecessarily disrupting the operations of insurance affiliated broker-dealers and investment advisers, or their fundamental link with insurance company organizational structures and distribution systems.

Consistent with FINRA Rule 2330, life insurers' programs generally provide production credits for the entire line of securities products that agents and representatives have authority to sell. Life insurance incentive programs do not diminish the broker-dealers' supervisory obligation because they retain full knowledge and control over the amount and form of representatives' compensation.[56]

Life insurers also comply with existing state insurance regulations that permit and firmly regulate non-cash compensation practices. Most notably, New York Insurance Code Section 4228 permits certain non-cash compensation practices regarding life insurance policies and annuities. The rule places monetary limits on the value of prizes and awards that insurers can provide agents.[57] The 22-page rule has extraterritoriality, meaning that Section 4228 governs all life insurance and annuity sales in

[56] Under, Internal Revenue Code definition of statutory employee, full time life insurance sales people must devote their principal business to the solicitation of life insurance or annuities primarily for one company. As statutory employees, career agents are eligible for the FICA match and certain employee benefits such as 401(k) and health insurance. Career agents selling proprietary products may earn credits for things such as a rent subsidy or a training allowance. All such programs must comply with applicable law, such as NY 4228, discussed in the text above and the following footnote.

[57] New York Insurance Code Section 4228(e)(6) provides: "A company, including any person, firm or corporation on its behalf or under any agreement with it, may pay or award, or permit to be paid or awarded, prizes and awards to agents and brokers pursuant to a plan of agent or broker compensation, provided that no single prize or award may exceed a value of two hundred fifty dollars, and that the total value of such prizes and awards paid or awarded to any agent or broker within a calendar year may not exceed one thousand dollars. Notwithstanding the foregoing, a company may also pay or award not more frequently than monthly a prize or award valued at not more than twenty-five dollars. The costs of all such prizes and awards shall not be included in applying the limits established in subsection (d) of this section. The superintendent may authorize higher limits on the value of prizes and awards than those set forth herein."

the United States for companies that sell life insurance or annuities in the State of New York.[58] An inconsistency between state and federal requirements is neither a desirable nor a necessary outcome, given the well-established practices in the life insurance industry and the regulatory safeguards that have long been in place.[59]

(B) The Regulatory Status of Non-Cash Compensation in the Life Insurance Industry

FINRA developed detailed regulations on cash and non-cash compensation standards governing variable insurance products through eight proposals spanning a *ten-year* period, which culminated in Rule 2320 in 1998.[60] The long hiatus between initial proposal and final adoption reflects the complexity of this issue and the deliberative rule governing it. This rule's administrative history established a rich source of interpretive guidance upon which broker-dealers relied since 1998. The SEC explicitly approved FINRA's amended rule on non-cash compensation based on the conditions of the rule and the explanation in FINRA's application for approval. The SEC also approved a largely parallel NASD Rule 2830 governing non-cash compensation in the sale of mutual funds.

Significantly, the SEC's Study on broker-dealers and investment advisers cataloged existing regulations governing non-cash compensation in the sale of securities.[61] The Study explained that "FINRA rules establish restrictions on the use of non-cash compensation in connection with the sale and distribution of mutual funds, variable annuities, direct participation program securities, public offerings of debt and equity securities, and real estate investment trust programs. These rules generally limit the way members can pay for or accept non-cash compensation and detail the types of non-cash compensation that are permissible."[62] Nothing in the legislative history of Section 913 of the Dodd-Frank Act, the SEC Study, or the Rand Report identified FINRA compliant non-cash compensation as an area in need of revision.

(C) Strict Limitations on Non-Cash Compensation Successfully Protect the Sales Process

FINRA Rules 2320 and 2830 strictly limits non-cash compensation in the sale of variable insurance products and investment companies to: (1) gifts of up to $100 per associated person annually; (2) an

[58] The New York Department of Financial Services website contains additional information about what steps life insurers must take to comply with Section 4228. http://www.dfs.ny.gov/insurance/life/agcomp/life4228.htm (last visited on July 31, 2018).
[59] The McCarran-Ferguson Act (15 U.S.C. §§ 1011-1015) and the Supreme Court's interpretation in *Barnett Bank, N.A. v. Nelson*, 517 U.S. 25 (1996) instruct that federal laws (SEC regulation in this case) should not contradict matters permitted under state insurance law unless the federal statute specifically relates to the regulation of insurance. By way of example, New York Insurance Regulation 4228 states that life insurers "may" provide some forms of noncash compensation. Possible limits on financial incentives (non-cash compensation) in Reg. BI may contradict this permissive provision about financial incentives in New York.
[60] *See* NASD NTM 88-17 (March 1988); NASD NTM 89-51 (July 1989); NASD NTM 91-25 (May 1991); NASD NTM 91-68 (May 1991); NASD NTM 94-67 (Oct. 1994); NASD NTM 95-56 (Sept 1995); NASD NTM 96-52 (August 1996); NASD NTM 97-50 (Aug. 1997); NASD NTM 98-75 (Sept. 1998). *See also* Wilkerson, *Recent Regulatory Developments Affecting Insurance Affiliated Broker-Dealers,* ALI-ABA conference on Life Insurance Company Products (Nov 1991) at 229; Krawczyk, *Recent Developments of Interest to Sellers of Variable Insurance Products, ALI-ABA Conference on Life Insurance Company Products* (Nov 1998) at 257.
[61] *See* http://www.sec.gov/news/studies/2011/913studyfinal.pdf at 68 (last visited on July 31, 2018).
[62] *Id.* The Study references the following FINRA non-cash compensation regulations: FINRA Rules 2310, 2320, and 5110, and NASD Rule 2830. *Id.* at note 311.

occasional meal, ticket to a sporting event or theater, or comparable entertainment; (3) payment or reimbursement for training and education meetings held by broker-dealers or issuers/sponsors for the purpose of educating associated persons of broker-dealers, so long as certain conditions are met; (4) in-house sales incentive programs of broker-dealers for their own associated persons; and (5) contributions by any company or other FINRA member to a broker-dealer's permissible in-house sales incentive program, subject to explicit conditions[63].

Rule 2320 requires broker-dealers to maintain records of all non-cash compensation received by the broker-dealer or its associated persons in permitted non-cash compensation arrangements. The records must include: the names of the offerors, companies or other broker-dealers making the non-cash compensation contributions; the names of the associated persons participating in the arrangements; the nature and value of non-cash compensation received; the location of training and education meetings; and any other information that proves compliance by the broker-dealer and its associated persons with the rule.

ACLI regularly compiles and digests all FINRA disciplinary actions to capture data involving the distribution of variable products and broker-dealers affiliated with life insurance companies. In a survey of the past five years, there have been no reported disciplinary actions involving non-cash compensation associated with variable products of broker-dealers affiliated with life insurers. It appears that Rule 2320 has operated to protect the integrity of the sales process and consumers. Nothing in the legislative history of Section 913 of the Dodd-Frank Act, the SEC's Study or the Rand Report suggests revisions to non-cash compensation practices.

(D) The Disruptive Economic Impact of Eliminating Non-Cash Compensation

Banning non-cash compensation could cause a reduction in the range and availability of products and services to consumers, something the SEC seeks to avoid, according to the narrative. Many insurance affiliated broker-dealers operate out of small offices serving local communities. Non-cash compensation under strict FINRA guidelines enables agents in these communities to travel to

[63] Non-cash compensation arrangements between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an affiliated member, are conditioned on: (i) the member's or non-member's non-cash compensation arrangement, if it includes variable contract securities, is based on the total production of associated persons with respect to all variable contract securities distributed by the member; (ii) the non-cash compensation arrangement requires that the credit received for each variable contract security is equally weighted; (iii) no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement; and (iv) the record keeping requirement in the rule is satisfied.

With regard to training and education meetings, the rule imposes strict additional conditions that require associated persons obtain their broker-dealer's prior approval to attend the meeting and that attendance by a member's associated persons is not conditioned by the member on the achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by the rule; (ii) the location is appropriate to the purpose of the meeting, which shall mean an office of the offeror or the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings; (iii) the payment or reimbursement is not applied to the expenses of guests of the associated person; and (iv) the payment or reimbursement by the offeror is not conditioned by the offeror on the achievement of a sales target or any other non-cash compensation arrangement allowed under the rule. These limitations successfully assure that training and education meetings are appropriate.

centralized training seminars and acquire enhanced skills and knowledge that empowers them to better serve consumers in their local communities. Some companies also utilize non-cash compensation to manage business expenses in the small offices often common in the life industry.

Unlike many wire-house broker-dealers operating in larger offices clustered around metropolitan centers, insurance affiliated investment professionals also serve the smaller markets throughout the country. Burdens on FINRA compliant non-cash compensation would disrupt life insurers' business models compared to wire-house broker-dealers and large investment advisory operations.

Elimination of FINRA compliant non-cash compensation practices would also cause structural and operational consequences. Following adoption of FINRA Rule 2320, broker-dealers distributing variable products implemented enterprise-wide compliance procedures and supervisory practices to fulfill the rule's mandates regarding non-cash compensation arrangements associated with life insurers' variable products. Likewise, compliance procedures were modified to accommodate parallel changes to NASD Rule 2830 governing non-cash compensation in mutual fund sales. Adjustment to revised non-cash compensation standards was a significant undertaking, and involved considerable expense and commitment to training, revised compliance procedures, supervision, and system changes.

Life insurance sales programs have existed for many decades and have not experienced significant changes in scope or approach. In these programs, the insurance broker-dealer has control over the suitability of the particular program, is responsible for the sales methods utilized to sell the offering and is in a position to exercise control over its sales force. These important features were specifically recognized by FINRA as it promulgated rules for non-cash compensation in variable products and mutual funds.

Life insurers support reasonable principles-based disclosure. The SEC's examination of incentives outlined in the Reg. BI release can be constructively addressed through the proposed disclosure approaches. Further, compliance with other regulatory structures provides coordinated consumer protection. This focused approach on the totality and layers of meaningful state and federal regulation achieves a worthwhile regulatory balance.

We respectfully offer this background to highlight the diversity within the broker-dealer universe. Reg. BI should appropriately accommodate different business models, organizational structures, product lines, and compliance and oversight operations. The SEC should carefully parse the unique structure, activities, and regulation of these limited-purpose broker-dealers and investment advisers affiliated with life insurers from the much broader functions and regulatory issues associated with wire-house broker-dealers and investment advisers with a broader range of services.

X. Life Insurers' Current Regulatory Framework

An updated assessment of the current regulatory framework is important to the SEC's ability to evaluate the range of potential regulatory actions. To that end, life insurance companies and their associated persons currently fulfill a broad array of regulation administered by state insurance departments, the Securities and Exchange Commission (SEC), the DOL, the Financial Industry Regulatory Authority (FINRA), and various state securities departments.

Existing comprehensive regulations govern important aspects of the customer relationship, including suitability standards, disclosure, advertising, supervision, maintenance of customer account assets, data collection, training, compensation, and supervision of associated persons. In general, the federal securities laws and FINRA rules govern individual variable insurance contracts, and state insurance laws and regulations apply to fixed insurance products. In some cases, insurance products invoke both federal and state laws. Collectively, this body of regulatory provisions and oversight provide important consumer protection and strong enforcement tools.[64]

We have attached an Appendix to highlight the extensive network of laws and regulations governing insurance product sales activities. Laws and regulations most relevant to Reg BI include:

- The National Association of Insurance Commissioners (NAIC) Suitability in Annuity Transactions Model Regulation;
- FINRA Rule 2330 governing suitability and supervision in the sale of variable annuities;
- FINRA Rule 2320 governing non-cash compensation for variable products and mutual funds;
- The NAIC Annuity Disclosure Model Regulation;
- The NAIC Model Replacements Regulation, and state insurance regulations such as New York Regulation 60 which governs replacements;
- The NAIC Unfair Trade Practices Act and the prohibition on "unfair financial planning practices;" and,
- State insurance consulting laws governing the simultaneous receipt of product commissions and fees for insurance consulting services.

Life Insurers provide significant written disclosures at the point of sale to satisfy multiple regulators' requirements and to help customers understand the nature of their various products and relationships. These disclosures include many product related materials (insurance sales illustrations, policy contracts, required "buyers' guides," prospectuses), marketing materials describing the firm's offerings, documents that provide the terms for a brokerage or advisory relationship (brokerage account agreements, advisory account agreements, Form ADV, investment policy statements), and other required disclosures.

Life insurers fulfill a considerable amount of post-sale disclosure depending on the nature of products and services provided, such as in-force insurance ledgers, transaction confirmations, periodic performance reporting for investment accounts, and updated Form ADV brochures. Several state and Federal laws are designed to ensure appropriate sales practices and suitable recommendations consistent with customers' financial objectives and best interests.

Insurance products are the only products in today's financial marketplace with free-look provisions extending for 10 or more days. These features give consumers a meaningful opportunity to carefully

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[64] The Treasury Report, *supra* note 18, emphasizes that "Treasury also recommends that the DOL and the SEC engage with state insurance regulators regarding the impact of standards of care on the annuities market. Given the size and scale of the annuities market, federal regulators should coordinate with the states in order to achieve consistent standards of conduct across product lines Treasury Report at 69.

evaluate purchases after the sale and to change their mind for any reason, including cost factors, to receive a refund.

The NAIC discussed state insurance regulatory standards[65] in a 2017 submission to the SEC that explained:

> *All annuity contracts, including fee-based annuity contracts, must comply with applicable state laws including those addressing, for example, required policy provisions, prohibited policy provisions, permitted exclusions and prohibited exclusions, policy format requirements, readability requirements and supporting documentation requirements, such as actuarial memorandum requirements.*
>
> *Generally, the policy, application, riders and endorsements are required to be submitted in the filing along with the actuarial documentation to demonstrate compliance with nonforfeiture requirements. Some states will perform prior review and approve the product for sale in advance ("prior approval") while other states permit insurers to file the product and sell it unless the product filing is disapproved by the regulator ("file and use.") In addition, 44 states and Puerto Rico, representing more than 75% of premium volume, are part of an Interstate Insurance Compact (Compact).*
>
> *The Compact established a multi-state public entity, the Interstate Insurance Product Regulation Commission (IIPRC), which serves as an instrumentality of the Member States. The IIPRC stands in the shoes of the compacting states and serves as a central point of electronic filing for certain insurance products, including life insurance, annuities, disability income, and long-term care insurance to develop uniform product standards, while at the same time affording a high level of protection to purchasers of asset protection insurance products.*

In summary, an updated assessment of the current state insurance regulatory framework is important for the SEC's equitable consideration of proposed Reg. BI. Partnership between state insurance regulators, the SEC, and FINRA will fulfill this commendable goal constructively.

XI. Preexisting Mechanisms and Current Endeavors Toward a Uniform State-Federal Best Interest Standard

Currently parallel state-Federal regulations provide a valuable comparative benchmark for the final revisions to Reg. BI. FINRA Variable Annuity Suitability and Supervision Rule 2330 strictly governs broker-dealers' sale of variable annuity contracts.[66] Rule 2330 is more restrictive and proscriptive than FINRA's general suitability and supervision rules for other securities. For example, unlike the supervision standards for other securities, Rule 2330 requires registered principals to review each variable annuity purchase and approve every purchase or exchange of a deferred variable annuity. In contrast, registered principals are not required to review and approve every registered

[65] *See* NAIC Comment on RIN 1210–AB82 Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions (Aug. 7, 2017) https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB82/00452.pdf (last visited on July 31, 2018).

[66] A detailed summary of the very detailed and specifically tailored requirement of FINRA Rule 2330 to variable annuities appears in Appendix A.

representative's general securities transactions recommendation. This important distinction warrants inclusively tailoring Reg. BI to accommodate all broker-dealer business models.

As further explained in Appendix A, Rule 2330 mandates very detailed standards for recommendations, documentation and signatures, tailored training for both registered representatives and principals, and confirmation that the customer would benefit from the features of a variable annuity. This rule assures that customers' needs are properly matched with products recommended.

In a directly parallel regulatory action, the National Association of Insurance Commissioners (NAIC) incorporated standards from FINRA suitability and supervision rules in the NAIC Suitability in Annuity Transactions Model Regulation. As a result, this Model Regulation ensures levels of protection for fixed annuity customers equal to those found in FINRA rules for variable annuity customers. The Model Regulation, therefore, provides a very effective means to implement a uniform state-Federal best interest standard that may be effectuated through FINRA's suitability and supervision rules.

The NAIC continues efforts to enhance its Suitability in Annuity Transactions Model Regulation to incorporate a best interest standard of care for annuities. During its March 24, 2018 meeting, the NAIC Annuity Suitability Working Group set aside a previously issued "Chair's Draft"[67] of proposed revisions to the Model Regulation and re-opened the Model Regulation for a 30-day public comment period seeking specific comments on any suggested revisions that would establish a best interest/consumer-focused approach and/or process for the sale of annuity products to consumers. ACLI submitted comments on April 27, 2018, with a "working draft" of proposed revisions that are consistent with ACLI best interest principles and align with key aspects of the SEC proposal.

ACLI's comments to the NAIC sought to ensure common uniform definitions, common disclosure requirements and common guiding elements among the states, the SEC and the DOL for the entities and individuals they regulate as each proceeds to develop new standards of care or revise their existing standards of care. The NAIC Working Group met in Kansas City between May 31 and June 1, 2018 to consider public comments. A new working draft is expected to be circulated to the Working Group for further discussion. The Working Group meets in person in Boston on August 4, 2018. We understand that the NAIC has met on multiple occasions with the SEC to align the NAIC and SEC efforts.

In its response[68] to a Request for Information (RFI) about the Fiduciary Rule, the NAIC explained that:

> *[I]n fulfilling the Congressional intent of Section 989j of the Dodd-Frank Act, we strive for an appropriate amount of regulatory consistency and harmony with other regulators across all uses and sales channels. Coordination and consultation with state and Federal securities regulators with the DOL at this critical juncture would ensure that our approaches are as consistent and compatible as possible to provide effective, clear standards for consumer protection, while avoiding excessive compliance burdens on the industry. We also hope to be a resource to the*

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[67] https://www.naic.org/meetings1712/cmte_a_aswg_2017_fall_nm_materials.pdf?1511814414901(last visited July 4, 2018).

[68] *See* NAIC Comment on RIN 1210–AB82 Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions (Aug. 7, 2017) https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB82/00452.pdf (last visited on July 31, 2018).

> *DOL as its evaluates the existing rule, how it fits with the existing regulation of insurance products and agent sales, and the impact of the rule on the insurance sector and retirement product purchasers.*[69]

Significantly, the NAIC also indicated in its comment on the RFI:

> *[I]f the SEC were to adopt revised standards of conduct for advisers or FINRA were to adopt best interest standards for registered representatives, those standards would involve supervisory systems that are generally recognized by state insurance regulators as complementary. Indeed, insurance regulation is currently in harmony with federal and state securities regulation for shared distribution channels. In addition, consumer protection is the hallmark of the state-based insurance regulatory system, and a robust regulatory framework upon which an exemption could be based already exists with respect to the sale of insurance and annuity products. In particular, state insurance regulators operate locally to their states and consumers, and can respond relative quickly to issues when they arise.*[70]

The NAIC further explained in its comments on the RFI that:

> *Market analysis and risk-based consumer protection by state insurance regulators, and insurance sector compliance, has significantly increased since the passage of Section 989J [of the Dodd-Frank Act]. While reconsideration of insurance adviser standards of conduct is warranted, the NAIC has a strong interest in avoiding insistent market regulation across the business of insurance. Notwithstanding the existing rules, we acknowledge that there is broad consensus among widely disparate groups for an updated and consistent standard for providing personalized investment advice to retail investors. Accordingly, we have been working to update our suitability standards and sales practices for life insurance and annuities. The NAIC is in the process of considering revisions to its suitability rules to potentially include a best interest standard of care… We strongly encourage [Federal] regulators to coordinate with us as we seek to update these rules.*[71]

In sum, FINRA and state insurance regulations provide a perfect benchmark for consistent, harmonious implementation of a best interest standard across state and Federal regulatory platforms. The NAIC has unequivocally indicated its desire to work with the SEC, FINRA, and DOL to develop a best interest standard. It is commendable, therefore, that the SEC continues to include state insurance regulators in the multi-regulator development of a best interest standard. A uniform best interest standard would then be jointly and constructively adopted across all regulatory platforms.

XII. Regulation Best Interest and America's Financial and Retirement Security Challenges

Retirement savers deserve standards ensuring continued access to a wide variety of retirement products, retirement savings information and related financial guidance from financial professionals acting in their best interest. With a workable Reg. BI, retirement savers will be able to obtain advice to meet their financial and retirement security needs.

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[69] *Id.* at 1.
[70] *Id.* at 2.
[71] *Id.* at 3.

Annuities play a significant part in today's retirement savings marketplace, particularly with respect to the retail IRA market. Indeed, DOL itself found that thirty-one percent of IRAs include investments in annuities.[72] The widespread use of annuities reflects the significant value that retirement investors attach to annuity products as a means to help save for retirement while also managing and balancing different retirement risks. Accordingly, in determining what is in a customer's best interest, an evaluation of the customer's anticipated future income needs is important.

An annuity is the only form of longevity protection in today's market. It allows investors to convert retirement savings into a stream of monthly guaranteed income for life—a process known as "annuitization." With the shift away from defined-benefit plans, without an annuity, a retiree now bears the risk of outliving his or her retirement savings. That risk is becoming only more significant as Americans live longer. An annuity enables the retirement saver to transfer that longevity risk—the risk they will live longer than expected—to the insurer. The 2017 Treasury Report on Asset Management and Insurance explained that "[b]ecause annuities are the only financial services product that can provide a guaranteed lifetime income stream, and because longevity risk (the risk of outliving one's assets) has become a key retirement concern, annuities are an important contributor to the Core Principle of empowering Americans to save for retirement."[73]

The peace of mind that annuities provide against longevity risk improves retirees' overall well-being and mental health. A study commissioned by the DOL "found that beneficiaries of lifelong-guaranteed income—such as from a privately-purchased annuity…were more satisfied in retirement and suffered from fewer depression symptoms than those without such income."[74] The "boost in well-being became stronger" the longer the person was retired—a finding "consistent with the notion that retirees who rely on finite savings and [defined-contribution] plan assets grow increasingly worried about funding retirement expenses as they grow older and deplete their assets, whereas recipients of lifelong-guaranteed income, other than from Social Security, are less concerned with outliving their resources."[75]

As noted above, life insurers fill a unique and important role in providing financial and retirement services to the less affluent and the middle-income markets that are neglected by other financial service institutions. Life insurance agents serve small towns across the country that are beyond the scope of other financial service providers. Most annuities today are sold through a transaction, commission-based compensation structure. The use of commissions to sell annuities also reflects the "buy and hold" nature of annuity products.

Importantly, despite the value of annuities to retirees' overall wellbeing, annuities are not well understood by consumers, who often need education about the value of these essential products with guaranteed lifetime income. Continued access to a full range of financial advice under a best interest standard of care will enable consumers to obtain essential information for educated purchase decisions. Life insurance salespersons help customers obtain core information through "needs analysis" programs, mandatory disclosures, comparative illustrations, and the elements of state and

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[72] *See*, *e.g.,* Fiduciary Investment Advice, Regulatory Impact Analysis 54 (Apr. 2015) ("Proposed RIA").

[73] Treasury Report, *supra* note 18, at 70.

[74] Michael J. Brien & Constantijn W.A. Panis, *Annuities in the Context of Defined Contribution Plans: A Study for the U.S. Department of Labor, Employee Benefits Security Administration* (Nov. 2011).

[75] *Id.*

Federal suitability obligations, among other things. This long-standing advisory and information-sharing process helps Americans conduct informed purchase decisions and enhances financial and retirement security. Reg. BI aligns with these important objectives.

XII. Definition of "Retail Customer" under Reg. BI

The Dodd-Frank Act defines "retail customer" as a natural person (or the legal representative of such natural person) who receives personalized investment advice from a BD or IA and who uses such advice primarily for personal, family, or household purposes. ACLI supported this provision in Section 913 of the Dodd-Frank Act. Reg. BI appropriately implements this foundational threshold.

Consistent with this definition, the final rule's explanation about the definition of "retail customer" should make clear that there is no BD, IA or other obligation to "look through" defined contribution pension plans to individual participants and their accounts. The provision of personalized investment advice should not extend to others beyond "retail customers." A focus on institutional investors would not provide any meaningful benefit and would simply serve to distract from the larger issue of how best to preserve and/or enhance investor protections for retail customers.

XIII. Sales Activity Compared to the Delivery of Personalized Investment Advice under Reg. BI

SEC action on Reg. BI should endeavor to satisfy the Dodd-Frank Act Section 913 mandate that it apply only to "personalized investment advice" about securities that is provided to "retail customers." Personalized investment advice about securities is investment advice that is provided to a retail customer based on the personal financial information provided by such retail customer, including the retail investor's financial needs, investment objectives, risk tolerance and financial circumstances.[76] It is, therefore, investment <u>advice</u> about securities that is intended to be specific to the retail customer and is intended to meet his or her specific financial circumstances, objectives and needs as well as the securities products or services which he or she is seeking.

The line between sales activity and advice is not only one that Congress itself has long recognized; it is a line that has constitutional significance. In-person sales conversations are commercial speech protected by the First Amendment of the Constitution.[77] Reg. BI should, therefore, be drawn to further substantial interests in protecting consumers and to avoid unduly restricting or burdening such speech, which can be a critical source of information for many retirement savers. The First Amendment requires that where sales speech is concerned, listeners must be trusted to make their own choices based on accurate, non-misleading commercial information.[78]

Sales activity should be differentiated from financial advisory activities. To do otherwise would ignore Congressional intent and unnecessarily blur business models and standards built on decades of

[76] In this connection, we note that the term "impersonal investment advice is defined under Advisers Act Rule 203A-3(a)(3)(ii) as "investment advisory services provided by means of written or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts."
[77] *See Sorrell v. IMS Health Inc.*, 564 U.S. 552, 557-558 (2011); *Edenfield v. Fane*, 507 U.S. 761, 765 (1993).
[78] *See, e.g., 44 Liquormart, Inc. v. Rhode Island*, 517 U.S. 484, 503 (1996) (plurality); *Edenfield v. Fane*, 507 U.S. 761, 767 (1993); *Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio*, 471 U.S. 626, 644-647 (1985); *Central Hudson Gas & Elec. Corp. v. Pubic Serv. Comm'n of N.Y.*, 447 U.S. 557, 561-562 (1980);

regulatory interpretation and invoke commercial speech issues under the First Amendment to the Constitution.

A. Advice as Distinguished from General Communications

Reg. BI's narrative release should avoid the unintended negative consequence of "chilling" contact and interactions between and among BDs, IAs, their respected associated persons and retail customers. There are numerous interactions between such BDs, IAs, their respective associated persons and retail customers that do not constitute personalized investment advice about securities. Accordingly, Reg. BI or any FINRA rulemaking should make clear that such types of non-personalized investment advice about securities with retail customers will not be deemed "personalized investment advice about securities." These include, but are not limited to:

- **General Education/ Impersonal Advice**. BDs, IAs and their associated persons provide general education and impersonal advice about securities and investments to retail customers and to broader audiences. Such information may include general concepts such as modern portfolio theory, asset diversification and asset allocation. This education and impersonal advice is not, however, intended to address the financial circumstances and/or needs of any particular individual(s) within the larger group – in fact it is typically delivered absent such specific retail customer information.

- **Account and Retail Customer Relationship Maintenance.** Depending on the business model and the nature of the relationship with the retail customer, as a matter of good business and compliance practices, financial professionals such as an associated person of a BD or IA may have - and should be encouraged to have - regular and frequent contact with applicable retail customers that often does not include the provision of personalized investment advice about securities.

    - For example, annual or quarterly contact with a retail customer to remind him or her to rebalance assets held in a variable annuity to match allocations set up at the time of contract purchase should not constitute "personalized investment advice about securities" absent, for example, efforts initiated by the associated person to recommend that the retail customer change the allocations percentages to accommodate changes in the retail customer's individual financial facts and circumstances.

- **Needs Analysis.** Financial professionals should be able to meet with retail customers as necessary to determine their current, and any new, investment objectives and financial needs without concern that doing so would impose an affirmative duty to render personalized investment advice about securities[79] (on an on-going or of an episodic nature) or that Reg. BI would apply to such interactions, unless the retail customer wishes to seek and the associated person is qualified to provide, and does provide, such

Linmark Assocs., Inc. v. Willingboro Twp., 431 U.S. 85, 96-97 (1977); *Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Council, Inc.*, 425 U.S. 748, 769-770 (1976). In a recent decision,

[79] *See* Section 913(g)(1)(k)(1) of the Dodd-Frank Act.

investment advice about securities.[80] An associated person should also not be affirmatively obligated to provide personalized investment advice simply because, for example, the associated person has communicated with a retail customer about their respective account(s) or contracts.

IX. Cost-Benefit Analysis in Reg. BI

The cost-benefit analysis accompanying Reg. BI does not include life insurers, their products or their distribution channels in its calculus. As noted above, certain aspects of Reg. BI and its interface with Form CRS are built on a template of full service broker-dealers. It is important that rulemaking include in its cost-benefit analysis the proposal's impact on all affected entities. FINRA compliant non-cash compensation associated with registered variable annuities and variable life insurance could be adversely affected if Reg. BI were to be interpreted to preclude those practices. Any limitations on this type of compensation needs careful and deliberative cost-benefit analysis. Likewise, any restrictive amendments to Reg. BI affecting limited purpose broker-dealers affiliated with life insurers must fulfill cost-benefit analysis standards governing federal agency rulemaking.[81]

[80] We recognize that any harmonized standard of care would apply if, and when, personalized investment advice about securities is provided to a retail customer.

[81] Executive branch mandates for cost-benefit analysis began in 1981 with Executive Order 12,291 that created a new procedure for the Office of Management and Budget (OMB) to review proposed agency regulations, and ensured the president would have greater control over agencies and improve the quality and consistency of agency rulemaking. Cost-benefit analysis formed the core of the review process. The order unambiguously stated that "regulatory action shall not be undertaken unless the potential benefits to society for the regulation outweigh the potential costs to society." 46 Fed. Reg. 13193, 13193 (Feb. 17, 1981). Regulatory agencies, therefore, must balance the benefits of proposed rules against their costs.

In 1993 Executive Order 12,866 superseded the 1981 order, but retained cost-benefit analysis as a fundamental requirement in rulemaking. Executive Order 12,866 instructs that "in deciding whether and how to regulate, agencies should assess all costs and benefits of available regulatory alternatives, including the alternative of not regulating." Exec. Order No. 12,866, 3 C.F.R. 638 (1993). In a manner parallel to the 1981 order, Executive Order 12,866 advises that agencies must perform their analysis and choose the regulatory approach that maximizes net benefits. The 1981 and the 1993 executive orders emphasize different approaches to the same cost –benefit end. The 1981order required that the benefits "outweigh" the costs, while the 1993 order required only that the benefits "justify" the costs. *See generally* Peter M. Shane, *Political Accountability in a System of Checks and Balances: The Case of Presidential Review of Rulemaking*, 48 ARK. L. REV. 161, 176-78 (1994) (comparison of 1981 and 1993 executive orders with additional detail and observing that the 1993 "order focuses on a similar mandate, but describes it with greater nuance").

President Obama reaffirmed the importance of cost-benefit analysis in 2011 through Executive Order 13,563, and reinforced the core principles in Executive Order 12,866 by emphasizing that "each agency must . . . propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs." Exec. Order 13,563, § 1(b), 76 Fed. Reg. 3821 (Jan. 18, 2011). The order further notes that "each agency is directed to use the best available techniques to quantify anticipated present and future benefits and costs as accurately as possible." Additional analysis of this order can be found in Helen G. Boutrous, *Regulatory Review in the Obama Administration: Cost-Benefit Analysis for Everyone*, 62 ADMIN. L. REV. 243, 260 (2010). Importantly, five administrations between 1981 to present have consistently made cost-benefit analysis a threshold for federal agency rulemaking.

X. Financial Literacy Solutions

The SEC identified American's financial literacy deficits as contributing factors to consumers' confusion about financial products, advice, and roles of financial professionals. The SEC's three coextensive initiatives are designed in response to financial literacy issues, in part. In its Section 917 Report under the Dodd-Frank Act, the SEC noted that "studies reviewed by the Library of Congress indicate that U.S. retail investors lack basic financial literacy. The studies demonstrate that investors have a weak grasp of elementary financial concepts." The SEC's three coextensive initiatives are designed in response to financial literacy issues, in part. The SEC's Section 917 Report also suggested layered disclosure as a solution to financial literacy challenges and defined it as an "approach to disclosure in which key information is sent or given to the investor and more detailed information is provided online and, upon request, is sent in paper or by e-mail."

ACLI has consistently supported layered disclosure in its submissions to the SEC on standards of conduct.[82] Layered disclosure prevents the inundation of consumers with lengthy disclosure that dilutes the value of important information and thwarts informed purchase decisions. Disclosure requirements under Reg. BI and Form CRS should allow broker-dealers to refer retail customers seeking more detailed disclosure to the entity's website where they can access such information (or allow them to receive a "hard copy" by request).[83]

The OMB provided federal agencies with extensive guidance to perform cost-benefit analysis in its Circular A-4.21 C , which identifies three fundamental elements to federal agency rulemaking: (i) a statement of the need for the proposed regulation; (ii) discussion of alternative regulatory approaches; and, (iii) an analysis of both qualitative and quantitative costs and benefits of the proposed action and the leading alternatives. Office of Mgmt. & Budget, Circular No. A-4, Regulatory Analysis (Sept. 17, 2003), last *available at* http:// www.whitehouse.gov/OMB/circulars/a004/a-4.pdf (last visited on July 31, 2018). OMB invited full public comment on his 48-page circular in draft form, which contains detailed instructions about conducing cost-benefit analysis and provides a standard template for running the analysis. The analysis should attempt to express both benefits and costs in a common measure—monetary units—to facilitate the assessment. When benefits or costs cannot be quantified in monetary terms or in some other quantitative measure, the agency should describe them qualitatively.

[82] ACLI submitted input on four SEC actions concerning broker-dealers and investment adviser standards of conduct, including:

- ACLI's response to the SEC Chairman's Request for Information about Standards of Conduct for Broker-Dealers and Investment Advisers (Oct. 3, 2017) found at https://www.sec.gov/comments/ia-bd-conduct-standards/cll4-2640466-161282.pdf.
- ACLI's July 5, 2013 Submission in response to the SEC's Request *for Data and Information on Brokers, Dealers and Investment Advisers*;
- ACLI's August 30, 2010 Submission in response to the SEC's request for information on its Study *on the Responsibilities of Brokers, Dealers, and Investment* Advisers in fulfillment of Section 913 of the Dodd-Frank Act; and,
- ACLI's December 13, 2007 Submission in response to the *RAND* Study *on Broker-Dealer and Investment Advisory Issues.*

[83] We urge that the SEC's consideration of disclosure requirements under Form CRS and Reg. BI would include a thorough analysis of the disclosures that retail customers currently receive. For example, when purchasing a deferred variable annuity, a retail (and other) customer must be informed of the general terms of various features of deferred variable annuities, such as surrender period and surrender charges; potential tax penalties; mortality and expense charges; investment advisory fees; potential charges for and features of riders; the insurance and investment components; and market risk. Additionally, such retail (and other) customers must

Another more direct means to address and improve American's financial literacy can be constructively achieved by the SEC and other regulators through comprehensive educational outreach, such as https://www.investor.gov/. Approaches such as this could more efficiently address the underlying causes of financial literacy than some of the indirect approaches in the SEC's three coextensive initiatives, particularly those that fit poorly in the proposals. Coordinated, plain-English, user-friendly financial and retirement education by state and federal regulators offers a practical solution to American's financial literacy challenges.[84]

XI. Opportunity for Supplemental Input

The SEC's three coextensive initiatives inviting comment (Reg. BI, Form CRS, and Investment Adviser Interpretations) totaled more than 1000 pages in their initial incarnation and contained over 1,500 specific questions. ACLI, like many commentators, reviewed and analyzed the three initiatives carefully within the 90-day comment period. Although we did not request a comment period extension in order not to delay the progress of the initiatives, it remains important to provide an opportunity to voice detailed input. Due to the length and depth of the initiatives, the SEC should entertain supplemental commentary for a reasonable period following the comment deadline.[85] This flexible approach will facilitate thorough input and scrutiny essential to federal agency rulemaking.

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be provided with a product prospectus, which provides a comprehensive and detailed description of the variable annuity. Finally, such retail (and other) customers are provided prospectuses for the mutual funds underlying the product subaccounts in which they invest. Simply piling more disclosure on top of the above-noted disclosure information is more likely to result in "information overload" than an enhanced understanding of the product or transaction by retail customers.

[84] ACLI developed comprehensive guidelines and instructions for life insurers on how to prepare disclosure documents for fixed, index, and variable annuities. *See*, Wilkerson, *ACLI Disclosure Initiative for Fixed, Index, and Variable Annuities: Constructive Change on the Horizon*, ALI-ABA Conference on Life Insurance Company Products (2007). The materials provided plain-English, streamlined, user-friendly point-of-sale disclosure. ACLI shared the guidelines with the SEC and FINRA, and incorporated all the constructive suggestions the SEC's Division of Investment Management staff offered in an informal process. Similarly, the NAIC's Deferred Annuity Buyers' Guide provides excellent streamlined, plain-English disclosure allowing apples to apples comparison of fixed, index and variable annuities, https://www.naic.org/documents/prod_serv_consumer_anb_la.pdf (Last visited July 31, 2018). ACLI's Guidelines and the NAIC Buyers' Guides provide a rich source of disclosure about essential information to an annuity purchase decision that may be useful as the SEC advances initiatives for broker-dealers and investment advisers.

[85] Industry groups like ACLI circulate regulatory proposals, elicit membership input, develop a consensus, and circulate draft letter of comment before submission. This worthwhile, but time intensive, process is difficult to execute in 90 days, particularly given the proposal's significance and complexity. The special time burdens confronting regulated industries and large organizations in digesting regulatory proposals were explicitly recognized by the Administrative Conference of the United States in its publication entitled *A Guide to Federal Agency Rulemaking* ("*Guide*"), which notes that:

> [i]nterested persons often are large organizations, which may need time to coordinate an organizational response, or to authorize expenditure of funds to do the research needed to produce informed comments.

See, A Guide to Federal Agency Rulemaking (1983) at 124. The American Bar Association updated and republished this *Guide* in 1998. *See* Lubbers, A Guide to Federal Agency Rulemaking, Third Edition (1998), American Bar Association, Government and Public Lawyers Division and Section of Administrative Law and Regulatory Practice. Subsequent citations to the Guide are to the updated and revised ABA publication.

XII. Reproposal of Reg. BI

If the SEC determines to more restrictively revise the provisions of Reg. BI, Form CRS or the Investment Adviser Interpretations that have been proposed, then the initiatives should be reproposed for public comment under federal agency rulemaking standards. Modifications that would make the initiatives more restrictive need to provide the opportunity to review, evaluate and offer commentary.[86]

XIII. Implementation Dates

In advancing any rulemaking and establishing compliance dates, the SEC should carefully consider that significant implementation issues that would likely be required. We respectfully request that Reg. BI provide an eighteen month implementation period that will allow and adequate opportunity to develop comprehensive enterprise-wide modifications supporting Reg. BI.

XIV. Conclusion

Reg. BI is a largely sensible, principles-based rule governing broker-dealer conduct. When providing personalized investment advice to retail customers, Reg. BI properly preserves and enhances:

- Investor protection for retail customers;
- Choice regarding securities products and services for the full spectrum of retail customers; and,

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The *Guide* reviews the legislative history of the Administrative Procedure Act (APA) and emphasizes that the notice of proposed rulemaking "must be sufficient to fairly apprise interested parties of the issues involved, so that they may present responsive data or argument." *(*Administrative Procedure Act: Legislative History, S. Doc. No.24879-258 (1946)) *See* Guide at 196. The *Guide* further explains that rules developed through notice and comment procedures must be rational, and that notice and opportunity for comment under §553 of the APA should properly "give interested persons a chance to submit available information to an agency to enhance the agency's knowledge of the subject matter of the rulemaking." *See* Guide at 197. The *Guide* also points out that "informal rulemaking procedures should provide interested persons an opportunity to challenge the factual assumptions on which the agency is proceeding and to show in what respect such assumptions are erroneous." *Id.* at 182 and 196.

[86] An agency adopting final rules that differ from its proposed rules is required to re-notice when changes are so major that original notice did not adequately frame the subjects for discussion; An agency need not re-notice changes that follow logically from or that reasonably develop the rules it proposed originally. 5 U.S.C.A. § 553. The purpose of a "new" notice is to allow interested parties a fair opportunity to comment upon the final rules in their altered form. Courts have consistently overturned rules where the final rule departs radically form the proposed rule, or where there was an inadequate analysis of the economic impact of the rule or amendment. *See, McCulloch Gas Processing Corp. v. Dept. of Energy,* 650 F.2d 1216 (1981) [rule invalid where no notice of major substantive modifications between the proposed rule and the rule as adopted]; *Accord, Natural Resources Defense Council, Inc. v. EPA,* 824 F.2d *(1987)* [rehearing ordered because provisions of final rule opposite proposal]*; American Medical Assn. v. United States,* 668 F. Supp. 1085 (1987); *American Frozen Food Institute v. Train,* 539 F. 2d 107 (1976); *Nat'l Black Media Coalition v. FCC,* 791 F.2d 1016 (1986) [when final rule not a "logical outgrowth" of NPRM, if the final rule deviates too sharply from the proposal, affected parties will be deprived of notice and an opportunity to respond to the proposal].

- Access to those products and services for the full spectrum of retail customers.

Similarly, Reg. BI constructively:

- Allows the retail customer and the BD (and as applicable their associated persons) to determine the scope and cost of services to be provided, including services to provide personalized investment advice about securities; and,
- Permits the disclosures provided to retail customers to be based upon, among other things, the securities products and/or services being offered and provides disclosure to retail customers that is useful.

To meet their financial and retirement security needs, retirement savers deserve standards ensuring continued access to a wide variety of retirement products, retirement savings information and related financial guidance from financial professionals acting in their best interest. Reg. BI achieves this important goal.

The SEC's inclusive outreach to state regulators and the National Association of Insurance Commissioners as partners in the development of a best interest standard is an essential element of effective oversight and regulation. Clarity, consistency and coordination across all regulatory platforms will best serve investors, and thwart regulatory arbitrage.

A full assessment about the current regulatory framework is important to the SEC's thorough evaluation of potential approaches under Reg. BI and should include the comprehensive network of state insurance regulation.

Finalization of Reg. BI should retain its neutral approach to business models, operations, compensation and products.

The implementation period accompanying Reg. BI should allow sufficient time for affected entities to make enterprise wide operational and system changes. Eighteen months is a reasonable time period for these significant implementation responsibilities.

We greatly appreciate your attention to our views. If any questions develop, please let me know.

Sincerely,

Carl B. Wilkerson

Carl B. Wilkerson

Federal and State Regulations Governing the Sale of Fixed and Variable Annuities: Comprehensive Protections for Financial and Retirement Product Consumers

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FINRA Rule 2330: Suitability and Supervision in the Sale of Variable Annuity Contracts

Carl B. Wilkerson, Vice President & Chief Counsel-Securities & Litigation
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I. Scope of This Outline Segment

A. FINRA Rule 2330 [Formerly NASD Rule 2821], which governs suitability and supervision in the sale of variable annuity contracts, was approved by the SEC in 2008, and was under development since 2004. The rule evolved through six different stages, five at the SEC, and one at FINRA.

B. This outline segment will summarize the elements of Rule 2330, and discuss its administrative history to illuminate FINRA's purpose and intent.

II. Substantive Overview: Rule 2330 has four primary provisions

A. Requirements governing recommendations, including a suitability obligation, specifically tailored to deferred variable annuity transactions;

B. Principal review and approval obligations;

C. A specific requirement for broker-dealers to establish and maintain written supervisory procedures reasonably designed to achieve compliance with the rule's standards; and,

D. A targeted training requirement for broker-dealers' associated persons, including registered principals.

III. The Rule's Requirements in Greater Detail

A. Revised Rule 2330 established the following specific requirements:

1. *Recommendation Requirements.* When recommending a deferred variable annuity transaction, Rule 2330 requires broker-dealers and salespersons to have a reasonable basis to believe that the: customer *has been informed of, in a general fashion,* the various features of the deferred variable annuity,

a) customer *would benefit from* certain features of a deferred variable annuity (e.g., tax-deferred growth, annuitization or a death benefit); and

b) the deferred variable annuity *as a whole* and the underlying sub-accounts or riders are suitable for the particular customer.

c) the particular deferred variable annuity that the registered representative is recommending, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity, and the riders and similar product enhancements are suitable (and in the case of an exchange, the transaction as a whole also is suitable) for the customer based on the information the registered representative is required to make a reasonable effort to obtain.

2. Revised Rule 2330 requires these determinations to be *documented and signed* by the salesperson recommending the transaction.

a) Rule 2330 would also require salespersons to make *reasonable efforts* to obtain information concerning customers' age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the variable annuity, investment time horizon, existing investment and insurance holdings, liquidity needs, liquid net worth, risk tolerance, tax status and other information used by the salesperson in making recommendations.

3. *Supervisory Review.* Rule 2330(c) requires that a principal review each variable annuity purchase or exchange within seven business days after the signed application arrives at the broker-dealer's office of supervisory jurisdiction in good order. A registered principal shall review and determine whether he or she approves of the purchase or exchange of the deferred variable annuity.

a) In reviewing the transaction, the registered principal would need to take into account the extent to which:

- the customer would benefit from certain features of a deferred variable annuity;
- the customer's age or liquidity needs make the investment inappropriate; and,
- the customer involved an exchange of a deferred variable annuity: will incur surrender charges, face a new surrender period, lose death or existing benefits,
- have increased mortality and expense fees, appears to have a need for any potential product enhancements and improvements,

or had another deferred variable annuity exchange within the preceding 36 months.

- Under Rule 2330, the supervisory review standards must be signed and documented by the registered principal that reviewed and approved the transaction.

4. *Supervisory Procedures.* Rule 2330 requires broker-dealers to establish and maintain specific written supervisory procedures reasonably designed to achieve and evidence compliance with the standards in Rule 2330. The broker-dealer must have procedures to screen and have principal review of the recommendations requirements in Rule 2330, and determine whether the salesperson has a particularly high rate of effecting deferred variable annuity exchanges.

5. *Training.* Under the proposal, broker-dealers would need to develop and document specific training policies or programs designed to ensure that salespersons recommending transactions, and registered principals who review transactions, in deferred variable annuities comply with the requirements of Rule 2330 and that they understand the material features of deferred variable annuities, including liquidity issues, sales charges, fees, tax treatment, and market risks.

6. *Automated Supervisory Review***.** FINRA's submission on the rule indicated that the rule would not preclude firms from using automated supervisory systems, or a mix of automated and manual supervisory systems, to facilitate compliance with the rule.

a) In addition, FINRA delineated what, at a minimum, a principal would need to do if his or her firm intends to rely on automated supervisory systems to comply with the proposed rule.

b) Specifically, a principal would need to (1) approve the criteria that the automated supervisory system uses, (2) audit and update the system as necessary to ensure compliance with the proposed rule, (3) review exception reports that the system creates, and (4) remain responsible for each transaction's compliance with the proposed rule.

c) Finally, FINRA noted that a principal would be responsible for any deficiency in the system's criteria that would result in the system not being reasonably designed to comply with the rule.

7. *Tax Qualified Plans.* Rule 2330 does not apply to variable annuity transactions made in connection with tax-qualified, employer-sponsored retirement or benefit plans that either are defined as a "qualified plan" under Section 3(a)(12)(C) of the Exchange Act or meet the requirements of Internal Revenue Code Sections 403(b) or 457(b), unless, in the case of any plan, the

broker-dealer makes recommendations to individual plan participants regarding the variable annuity.

IV. Review and Explanation of (Revised) Rule 2330

A. Supervisory review standards changed

1. FINRA enlarged the time period for supervisory review to seven days after the signed application arrives at the broker-dealer's OSJ in good order.

a) Compare to *prior* draft: "Prior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing, but *no later than seven business days after the customer signs the application*, a registered principal shall review and determine whether he or she approves of the purchase or exchange of the deferred variable annuity."

b) Compare to earlier draft: the third amendment required the principal must review and approve the transaction "[n]o later than *two business days following* the date when a member or person associated with a member *transmits a customer's application* for a deferred variable annuity to the issuing insurance company for processing or *five business days from the transmittal date* if additional contact with the customer or person associated with the member is necessary in the course of the review."

2. FINRA rationale: ensuring that all broker-dealers have adequate time to perform a thorough principal review of these transactions.

a) In view of the variety of features and provisions in connection with the issuance of deferred variable annuity contracts, FINRA became persuaded that principal review of variable annuity sales requires greater time than reviews of many other securities transactions.

b) The provision of a reasonable amount of time for pre-transmittal review, however, posed potential problems related to other rules concerning the prompt handling of customer funds.

(1) For instance, FINRA Rule 2330 states generally that member firms shall not make improper use of customer funds, and FINRA Rule 2820 specifically requires member firms to "transmit promptly" the application and the purchase payment for a variable contract to the issuing insurance company.

(2) Similarly, Rules 15c3-1 and 15c3-3 under the 1934 Act require certain member firms to promptly transmit and forward funds.

(3) Rules 15c3-1(c)(9) and (10) under the 1934 Act define the terms "promptly transmit and deliver" and "promptly forward" funds as meaning "no later than noon of the next business day after receipt of such funds."

3. FINRA solution to regulatory conflicts with prompt pricing standards:

a) FINRA asked for, and obtained from the SEC, regulatory relief regarding Rules 15c3-1 and 15c3-3 when the same circumstances exist. As a companion to the rule approval, the SEC provided an exemptive order from the prompt pricing provisions.

b) FINRA made clear that a broker-dealer that is holding an application for a deferred variable annuity and a non-negotiated check from a customer written to an insurance company for a period of seven business days or less would not be in violation of FINRA Rules 2330 if the reason that the application and check are being held is to allow a principal to complete his or her review of the transaction pursuant to proposed Rule 2330.

B. Recommendation requirements revised

1. FINRA revised proposed Rule 2821to state that "[n]o member or person associated with a member shall recommend to any customer the purchase or exchange of a deferred variable annuity unless such member or person associated with a member *has a reasonable basis to believe* that the transaction is suitable in accordance with Rule 2310."

2. FINRA is substituting the phrase "has a reasonable basis to believe" for "has determined," which appeared in the prior draft of the rule.

3. FINRA rationale: FINRA softened the review requirement in response to comments that the reasonable basis standard was more strict than with other similar financial products.

C. Non-recommended transactions conditionally excluded. FINRA revised the rule conditionally so that it does not apply to non-recommended transactions, such as situations where the member is acting solely as an order taker. FINRA believed Rule 2821 should not prevent a fully informed customer from making his or her own investment decision.

1. Conditional exclusion from rule, however.

a) A registered principal "may authorize the processing of the transaction if the registered principal determines that the transaction was not recommended and that the customer, after being informed of the reason why the registered principal has not approved the transaction, affirms that he or she wants to proceed with the purchase or exchange of the deferred variable annuity."

2. FINRA rationale:

a) Change allows a customer to decide to continue with the non-recommended purchase or exchange of a deferred variable annuity

notwithstanding the broker-dealer's belief that the transaction would be viewed as unsuitable if it had been recommended.

b) The new requirement that the principal independently determine that the transaction was not recommended adds another layer of protection. Requirement "should discourage salespersons from attempting to bypass compliance requirements for recommended sales by simply checking the 'not recommended' box on a form."

c) Customers must indicate an explicit intent to continue with the non-recommended transaction notwithstanding the unsuitability determination, which will help ensure that the customer's decision is an informed one.

D. *"Undue concentration" standard eliminated.* FINRA eliminated prior requirements that registered principals consider "the extent to which the amount of money invested would result in an undue concentration in a deferred variable annuity."

E. The annuity or deferred variable annuities should be evaluated in "the context of the customer's overall investment portfolio."

1. FINRA Rationale:

a) Requirement was unclear and could cause confusion. Because other provisions in Rule 2330 already capture the important aspects of this "undue concentration" determination, FINRA has eliminated it as superfluous.

F. Generic disclosure allowed

1. Under recommendation requirements, FINRA clarified that required disclosure may be generic and not specific to the product. Clarification now requires that "the customer has been informed, *in general terms*, of various features of deferred variable annuities. . . ."

2. FINRA rationale:

a) Simply a clearer statement of original rule's intent.

G. "Unique features" requirement relaxed and expanded

1. Provision now states that salesperson must have "a reasonable basis to believe that . . . the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit."

2. FINRA Rationale:

a) FINRA accepted commenters' position that there are other financial products that have features similar to those of a deferred variable annuity,

so a requirement that the customer would benefit from the *unique* features was relaxed to benefiting from *certain* features.

b) Living benefits added to the list of certain features that may be beneficial for customer in addition to death benefit.

H. Required surveillance practices for replacement activities clarified

1. FINRA indicated that principal need not examine *every* transaction when salesperson has a potentially higher rate of replacement sales. FINRA emphasized instead review on a periodic basis via exception reporting rather than as part of the principal review of each exchange transaction

2. FINRA revised the supervisory procedures guarding against inappropriate replacement practices so that, "the member also must (1) implement surveillance procedures to determine if the member's associated persons have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of this Rule, other applicable FINRA rules, or the federal securities laws ("inappropriate exchanges") and (2) have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges."

FINRA Rule 2320: FINRA Rules Governing Non-Cash Compensation in the Sale of Variable Contracts and Mutual Funds

Carl B. Wilkerson, Vice President & Chief Counsel-Securities & Litigation
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I. Scope of This Outline Segment

A. This Outline Segment addresses the permitted uses of non-cash compensation in the sale of variable contracts and mutual funds. FINRA significantly modified this rule to reduce the range of permitted non-cash compensation arrangements.

B. FINRA's non-cash compensation rule does not apply to fixed annuities because they are excluded from the definition of security under the Federal securities laws.

1. Fixed index annuities are excluded from categorization as securities under the Harkin Amendment to the Dodd-Frank Act, the Harkin Amendment conditions its protections to compliance with the NAIC's Suitability in Annuity Transactions Model Regulation or substantially similar features of that amendment.

2. Absent compliance with the NAIC's Suitability in Annuity Transactions Model Regulation or similar provisions, fixed index annuities could lose their immunity from the Federal securities laws and distributors of this product could, therefore, be subject to FINRA requirements, including the non-cash compensation rule.

II. FINRA Rules Governing Non-Cash Compensation.

A. In 1998, FINRA adopted Rule 2320 which governs non-cash compensation. A parallel non-cash compensation rule exists for mutual funds in FINRA Rule 2341(L)(5). A supplemental FINRA Q & A addresses a number of questions on the rules' applicability to specific situations, and contains a good thumbnail summary about the rules.

B. FINRA Rule 2320 prevents abuses and strictly limits non-cash compensation in the sale of variable insurance products to:

1. Gifts of up to $100 per associated person annually;

2. An occasional meal, ticket to a sporting event or theater, or comparable entertainment;

3. Payment or reimbursement for training and education meetings held by broker-dealers or issuers/sponsors for the purpose of educating associated persons of broker-dealers, so long as certain conditions are met;

4. In-house sales incentive programs of broker-dealers for their own associated persons; and,

5. Contributions by any company or other FINRA member to a broker-dealer's permissible in-house sales incentive program, subject to explicit conditions.

C. Non-cash compensation arrangements between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an affiliated member, are conditioned on:

1. The member's or nonmember's non-cash compensation arrangement, if it includes variable contract securities, is based on the total production of associated persons with respect to all variable contract securities distributed by the member;

2. The non-cash compensation arrangement requires that the credit received for each variable contract security is equally weighted;

3. No unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or nonmember's organization of a permissible non-cash compensation arrangement; and

4. The record keeping requirement in the rule is satisfied. Rule 2320 requires broker-dealers to maintain records of all non-cash compensation received by the broker-dealer or its associated persons in permitted non-cash compensation.

D. FINRA Pending Proposal to Revise Non-Cash Compensation Rules.

1. In August 2016, FINRA proposed several amendments to the non-cash compensation rules that are pending closure and SEC approval. The proposed FINRA amendments would:

a) Consolidate the rules under a single rule series in the FINRA rulebook;

b) Increase the gift limit from $100 to $175 per person per year and include a *de minimis* threshold below which firms would not have to keep records of gifts given or received;

c) Amend the non-cash compensation rules to cover all securities products, rather than only direct participation programs (DPPs), variable insurance contracts, investment company securities and public offerings of securities; and,

d) Incorporate existing guidance and interpretive letters into the rules.

2. Additionally, FINRA proposed a revised approach to internal sales contests for non-cash compensation such that if payment or reimbursement of expenses associated with the non-cash compensation arrangement is preconditioned on achievement of a sales target, the non-cash compensation arrangement must:

a) Be based on the total production with respect to all securities products; and,

b) Not be based on conditions that would encourage an associated person to recommend particular securities or categories of securities.

3. Finally, FINRA proposed to incorporate into the amended rules a principles-based standard for business entertainment that would require firms to adopt written policies and supervisory procedures for business entertainment arrangements.

a) The records must include: the names of the offerors, companies or other broker-dealers making the non-cash compensation contributions; the names of the associated persons participating in the arrangements; the nature and value of non-cash compensation received; the location of training and education meetings; and any other information that proves compliance by the broker-dealer and its associated persons with the rule.

NAIC Suitability in Annuity Transactions Model Regulation: A Coordinated Approach to Suitability and Supervision in the Sale of Individual Annuity Contracts

Carl B. Wilkerson, Vice President & Chief Counsel-Securities & Litigation
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I. NAIC Suitability and Supervision Responsibilities in NAIC Model Regulation Governing Individual Annuity Sales

A. The National Association of Insurance Commissioners (NAIC) adopted several evolving sets of revisions to its model regulation governing suitability and supervision in the sale of individual annuity contracts.

1. The NAIC's initial regulation was entitled the Senior Protection in Annuity Transactions Regulation, and governed suitability and supervision in annuity transactions with "senior consumers" age 65 or older.

2. The NAIC's 2006 revision to this regulation applied it to all individual annuity sales. To reflect the broader application of the regulation, it was re-titled the Suitability in Annuity Transactions Model Regulation. This regulation incorporated suitability and supervision practices parallel to those under the federal securities laws and FINRA rules.

3. In 2010, the NAIC added further amendments to the Suitability in Annuity Transactions Model Regulation. Among other things, the 2010 NAIC revisions to the regulation established new restrictions on supervisory delegation to third-party and reliance on producer suitability recommendations, established a new producer training requirement (which must be completed by producers prior to their being able to solicit the sale of annuities), and expanded powers of Commissioners to levy sanctions and penalties.

B. The evolving iterations of the NAIC model regulation can be found at NAIC Model Regulation Service II-275-1 (2010). Over 30 states have implemented the 2010 version of the model regulation and two have proposed the regulation for adoption. 14 states have adopted the 2006 version of the regulation. Over time, these states are expected to incorporate the 2010 revisions as they update their regulations.

C. Because the 2010 amendments to the model regulation are built upon the original 2006 model, the 2006 model is discussed first. The 2010 modifications to the model are summarized separately below, following the 2006 regulation's summary.

D. ACLI supports strong suitability standards to ensure annuity sales recommendations are suitable and will promote consumer confidence in making informed annuity purchase decisions.

II. Approach of the 2006 Revised NAIC Regulation

A. The regulation establishes standards and procedures governing recommendations in annuity transactions, to ensure "that insurance needs and financial objectives of consumers at the time of the transaction are appropriately addressed."

B. The regulation imposes suitability and supervision duties for insurers and insurance producers, including requirements for maintaining written procedures and conducting periodic reviews of records to detect and prevent unsuitable sales practices.

III. Scope and Governing Framework of the 2006 Revised NAIC Regulation

A. The regulation applies to any recommendation to purchase or exchange an annuity made to a consumer by an insurance producer, or an insurer where no producer is involved, that results in the purchase or exchange recommended.

1. "Annuity" means a *fixed annuity or variable annuity* that is *individually solicited*, whether the product is classified as an individual or group annuity [Section 5 (A)].

2. "Recommendation" means advice provided by an insurance producer, or an insurer where no producer is involved, to an individual consumer that results in a purchase or exchange of an annuity in accordance with that advice [Section 5(D)].

B. The regulation does not apply to annuity transactions involving:

1. Direct response solicitations where there is no recommendation based on information collected from the consumer under the regulation;

2. Contracts funding specified retirement plans:

a) An employee pension or welfare benefit plan that is covered by the Employee Retirement and Income Security Act (ERISA);

b) A plan described by Sections 401(a), 401(k), 403(b), 408(k) or 408(p) of the Internal Revenue Code (IRC), as amended, if established or maintained by an employer;

c) A government or church plan defined in Section 414 of the IRC, a government or church welfare benefit plan, or a deferred compensation plan of a state or local government or tax exempt organization under Section 457 of the IRC;

d) A nonqualified deferred compensation arrangement established or maintained by an employer or plan sponsor;

3. Settlements of, or assumptions of, liabilities associated with personal injury litigation or any dispute or claim resolution process; or

4. Formal prepaid funeral contracts.

IV. Duties Imposed Under the Regulation [Section 6]

A. **Suitability Standard**: In recommending to a consumer the purchase of an annuity or the exchange of an annuity that results in another insurance transaction or series of insurance transactions, the insurance producer, or the insurer where no producer is involved, shall have reasonable grounds for believing that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer as to his or her investments and other insurance products and as to his or her financial situation and needs.

1. "Insurer" means a company required to be licensed under the laws of this state to provide insurance products, including annuities.

2. "Insurance producer" means a person required to be licensed under the laws of this state to sell, solicit or negotiate insurance, including annuities.

3. Note: this suitability standard directly parallels the general standard of FINRA Suitability Rule 2310(a), set forth at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000466 .

B. **Suitability Ingredients** [Section 6(A)]: Prior to the execution of a purchase or exchange of an annuity resulting from a recommendation, an insurance producer, or an insurer where no producer is involved, shall make reasonable efforts to obtain information concerning:

1. The consumer's financial status;

2. The consumer's tax status;

3. The consumer's investment objectives; and

4. Such other information used or considered to be reasonable by the insurance producer, or the insurer where no producer is involved, in making recommendations to the consumer.

5. Note: the suitability ingredients above precisely track those in FINRA Suitability Rule 2320(b) set forth at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000466 .

6. An insurer or insurance producer's recommendation under the suitability standard and ingredients must be reasonable under all the circumstances actually known to the insurer or insurance producer at the time of the recommendation [Section 6(c)(2)].

a) Neither an insurance producer, nor an insurer where no producer is involved, has any obligation to a consumer under the

suitability standard [Section 6(a)] related to any recommendation if a consumer:

(1) Refuses to provide relevant information requested by the insurer or insurance producer;

(2) Decides to enter into an insurance transaction that is not based on a recommendation of the insurer or insurance producer; or

(3) Fails to provide complete or accurate information.

(4) Note: these narrow exclusions directly parallel FINRA approaches to suitability in Rule 2310.

C. **Supervision Standard**

1. For insurers:

a) An insurer either (i) shall assure that a system to supervise recommendations that is reasonably designed to achieve compliance with the suitability standards in the regulation is established and maintained, or (ii) shall establish and maintain such a system, including, but not limited to:

(1) Maintaining written procedures; and

(2) Conducting periodic reviews of its records that are reasonably designed to assist in detecting and preventing violations of this regulation.

b) To fulfill the supervision standard, an insurer may contract with a third party, including a general agent or independent agency, to establish and maintain a system of supervision as required by Section 6(D)(1) regarding insurance producers under contract with, or employed by, the third party.

(1) To utilize a third party for supervision, an insurer must make reasonable inquiry to assure that the third party is performing the functions required under the regulation, and must take reasonable action under the circumstances to enforce the contractual obligation of the third party to perform the functions.

(2) An insurer may comply with its obligation to make reasonable inquiry by doing all of the following:

(a) Annually *obtain a certification* from a third party senior manager who has responsibility for the delegated functions that the manager has a reasonable basis to represent, and does represent,

that the third party is performing the required functions; and

(b) Based on reasonable selection criteria, periodically select third parties for review to determine whether the third parties are performing the required functions. The insurer must perform those procedures to conduct the review that are reasonable under the circumstances.

c) Insurers that contract with a third party to perform supervision and that comply with the certification and periodic review procedures will fulfill their supervisory responsibilities under the regulation.

d) Note: the supervisory approaches implemented in the regulation parallel those in FINRA Rule 3010(a).

e) No one may provide a certification under the regulations supervisory delegation unless:

(1) The person is a senior manager with responsibility for the delegated functions; and

(2) The person has a reasonable basis for making the certification

2. For insurance producers:

a) A general agent and independent agency either must (i) adopt a system established by an insurer to supervise recommendations of its insurance producers that is reasonably designed to achieve compliance with the regulation, or (ii) establish and maintain such a system, including, but not limited to:

(1) Maintaining written procedures; and

(2) Conducting periodic reviews of records that are reasonably designed to assist in detecting and preventing violations of this regulation.

3. Scope of required system of supervision for insurers and producers:

a) An insurer, general agent or independent agency is not required to review, or provide for review of, all insurance producer solicited transactions; or

b) An insurer, general agent or independent agency is not required to include in its system of supervision an insurance producer's recommendations to consumers of products other than

the annuities offered by the insurer, general agent or independent agency.

c) Note: these clarifications to the scope of the supervisory requirements parallel those applied under FINRA Rule 3010.

4. Deference to FINRA Suitability rule for variable annuity sales:

a) Compliance with FINRA's suitability rule will satisfy the regulation's suitability requirements for variable annuity recommendations.

b) Deference to FINRA suitability standards and practices in variable annuity sales does not, however, limit the insurance commissioner's ability to enforce the regulation.

D. **Recordkeeping**

1. Insurers, general agents, independent agencies and insurance producers must maintain or be able to make available to the commissioner records of the information collected from the consumer and other information used in making the recommendations that were the basis for insurance transactions for [a specified number of] years after the insurance transaction is completed by the insurer.

2. An insurer is permitted, but shall not be required, to maintain documentation on behalf of an insurance producer.

3. Records required to be maintained by this regulation may be maintained in paper, photographic, microprocess, magnetic, mechanical or electronic media or by any process that accurately reproduces the actual document.

E. **Enforcement Powers and Mitigation Provisions**

1. To implement the regulation, the state insurance commissioner may order:

a) An insurer to take reasonably appropriate corrective action for any consumer harmed by the insurer's, or by its insurance producer's, violation of this regulation;

b) An insurance producer to take reasonably appropriate corrective action for any consumer harmed by the insurance producer's violation of this regulation; and

2. Any applicable penalty under the state code may be reduced or eliminated if corrective action for the consumer was taken promptly after a violation was discovered.

V. Overview of the Modifications in the 2010 Revised NAIC Suitability in Annuity Transactions Model Regulation

A. Insurance producers are required to obtain information about the customer's needs and financial objectives when formulating a recommendation for an annuity purchase and must have reasonable belief that the recommendation is suitable. (NAIC Model Sec. 6(A)&(B)).

B. Insurers must assure that a system is in place to supervise compliance with the Model, including review of producers' recommendations. (NAIC Model Sec. 6(F)(1)(d)).

C. An insurer must conduct reviews of its records to assist in detecting and preventing violations of the regulation. (NAIC Model Sec. 6(F)(1)(e).

D. When an insurer contracts with a third party to establish a system of supervision, the insurer must monitor and audit, as appropriate, to assure that the third party is performing the required functions. (NAIC Model Sec. 6(F)(2)(b)(i)).

E. When an insurer relies on a third party to perform required suitability functions, the third party, when requested by the insurer, must give a certification that it is performing the functions in compliance with the regulation. (NAIC Model Sec. 6(F)(2)(b)(ii)).

F. Sales of annuities made in compliance with stringent federal securities rules pertaining to suitability and supervision (FINRA Rule 2330) satisfy the requirements under the Model. (NAIC Model Sec. 6(H)).

G. An insurance producer shall not solicit the sale of an annuity unless the producer has adequate knowledge of the product and shall be in compliance with the insurer's product training standards. (NAIC Model Sec. 7(A).

H. Insurance producers who engage in the sale of annuities must complete an annuity training course approved by the appropriate State. (NAIC Model Sec. 7(B)).

I. The Commissioner may order that an insurer or producer take appropriate corrective action for any consumer harmed by the insurer's, or producer's, violation of the regulation. (NAIC Model Sec. 8(A)(1)&(2)).

The NAIC Annuity Disclosure Model Regulation:
Disclosure Standards in Annuity Distribution

Carl B. Wilkerson, Vice President & Chief Counsel-Securities & Litigation
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I. Scope of Outline

A. This outline summarizes the elements of the NAIC Annuity Disclosure Model Regulation, the required Disclosure Statement and the required NAIC Buyer's Guide to Fixed, Indexed and Variable Annuities.

B. The NAIC Annuity Disclosure Model Regulation can be found at NAIC Model Reporting Service 245-I (April 2016).

II. Objective of the Annuity Disclosure Model Regulation

A. To provide standards for the disclosure of certain minimum information about annuity contracts to protect consumers and foster consumer education.

1. The regulation specifies the minimum information which must be disclosed and the method and timing of delivering it.

2. The regulation seeks to ensure that purchasers of annuity contracts understand certain basic features of annuity contracts.

III. Annuities Covered by the Regulation

A. All group and individual annuity contracts, except:

1. Registered or non-registered variable annuities.

2. Immediate and deferred annuities having only non-guaranteed elements.

3. Annuities used to fund:

a) An employee pension plan which is covered by the Employee Retirement Income Security Act (ERISA);

b) A plan described by Sections 401(a), 401(k) or 403(b) of the Internal Revenue Code, where the plan, for purposes of ERISA, is established or maintained by an employer,

c) A governmental or church plan defined in Section 414 or a deferred compensation plan of a state or local government or a tax exempt organization under Section 457 of the Internal Revenue Code; or

d) A nonqualified deferred compensation arrangement established or maintained by an employer or plan sponsor.

4. Structured Settlement Annuities.

5. Note: Under the model regulation, states may optionally elect to exclude charitable gift annuities and structured settlement annuities also.

IV. Information Mandated in Required NAIC Disclosure Statement

A. The generic name of the contract, the company product name, if different, form number, and the fact that it is an annuity;

B. The insurer's name and address;

C. A description of the contract and its benefits, emphasizing its long-term nature, including examples where appropriate:

1. The guaranteed, non-guaranteed and determinable elements of the contract, and their limitations, if any, and an explanation of how they operate;

2. An explanation of the initial crediting rate, specifying any bonus or introductory portion, the duration of the rate and the fact that rates may change from time to time and are not guaranteed;

3. Periodic income options both on a guaranteed and non-guaranteed basis;

4. Any value reductions caused by withdrawals from or surrender of the contract;

5. How values in the contract can be accessed;

6. The death benefit, if available, and how it will be calculated;

7. A summary of the federal tax status of the contract and any penalties applicable on withdrawal of values from the contract; and

8. Impact of any rider, such as a long-term care rider.

D. Specific dollar amount or percentage charges and fees, which must be listed with an explanation of how they apply.

E. Information about the current guaranteed rate for new contracts that contains a clear notice that the rate is subject to change.

F. Insurers must define terms used in the disclosure statement in language understandable by a typical person in the target market.

V. Required NAIC Buyer's Guide to Fixed Deferred Annuities (appears at the end of the outline).

A. A Buyer's Guide prepared by the NAIC provides information about different aspects of annuities, such as

1. What an annuity is.

2. Descriptions of the different kinds of annuities.

    a) Single premium or multiple premium.

    b) Immediate or deferred.

    c) Fixed or variable.

3. How interest rates are set for the deferred variable annuity.

    a) Explanation of current interest rate.

    b) Explanation of minimum guaranteed rate.

    c) Explanation of multiple interest rates.

4. Description of charges in the contract.

    a) Surrender or withdrawal charges.

    b) Free withdrawal features.

    c) Contract fee.

    d) Transaction fee.

    e) Percentage of premium charge.

    f) Premium tax charge.

5. Fixed Annuity Benefits

    a) Annuity income payments.

    b) Annuity payment options.

        (1) Life only.

        (2) Life annuity with period certain.

        (3) Joint and survivor.

VI. Timetable for Delivery of Required Disclosure Statement and Buyers' Guide:

A. At or before the time of application if annuity application is taken in a *face-to-face meeting*.

B. No later than five (5) business days after the completed application is received by the insurer, if annuity application is taken by means *other than in a face-to-face meeting*.

1. With applications received from a *direct solicitation through the mail*:

    a) Inclusion of a Buyer's Guide and Disclosure Statement in the direct mail solicitation satisfies the requirement for delivery no later than five (5) business days after receipt of the application.

2. For applications received via the Internet:

    a) Taking reasonable steps to make the Buyer's Guide and Disclosure Statement available for viewing and printing on the insurer's website satisfies the requirement for delivery no later than five (5) business day of receipt of the application.

3. Annuity solicitations in other than face-to-face meetings must include a statement that the proposed applicant may contact the insurance department of the state for a free annuity Buyer's Guide. Alternatively, the insurer may include a statement that the prospective applicant may contact the insurer for a free annuity Buyer's Guide.

4. *Extended Free-Look Period*: where the Buyer's Guide and disclosure document are not provided at or before the time of application, a free look period of no less than fifteen (15) days shall be provided for the applicant to return the annuity contract without penalty. The free look runs concurrently with any other free look provided under state law or regulation.

VII. Required Report to Contract Owners

A. For annuities in the payout period with changes in non-guaranteed elements and for the accumulation period of a deferred annuity, the insurer

must provide each contract owner with a report, *at least annually*, on the status of the contract that contains at least the following information:

1. The beginning and end date of the current report period;

2. The accumulation and cash surrender value, if any, at the end of the previous report period and at the end of the current report period;

3. The total amounts, if any, that have been credited, charged to the contract value or paid during the current report period; and

4. The amount of outstanding loans, if any, as of the end of the current report period.

VIII. The NAIC Annuity Buyers' Guide is accessible through an embedded link on page 51.

NAIC Insurance and Annuities Replacement Model Regulation:
A Systemic Approach to Appropriate Sales Practices

Carl B. Wilkerson, Vice President & Chief Counsel-Securities & Litigation
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I. NAIC Insurance and Annuities Replacement Model Regulation

A. In June 2000, the NAIC adopted substantial amendments to the 1998 Insurance and Annuities Replacement Model Regulation. This regulation establishes substantial protections for consumers through required systems of supervision, control, monitoring, and recordkeeping for insurers and producers. Additionally, the regulation requires plain-English notices, and signed disclosure about the replacement transaction.

1. The NAIC's Model Regulation and amendments promote uniformity among state insurance regulations.

2. Citation: Insurance and Annuities Replacement Model Regulation, NAIC Model Regulation Service-July 2006 at III-621-1.

B. **Approach of the amended regulation**

1. The amended regulation establishes duties for insurance producers, replacing insurers, and existing insurers designed to protect consumers.

    a. For example, insurers using insurance producers must, among other things:

        (1) Maintain a *system of supervision and control*;

        (2) Have the *capacity to monitor* each producer's life and annuity replacements for that insurer;

        (3) Ascertain that required *sales material and illustrations are complete and accurate*; and

        (4) *Maintain records* of required notification forms and illustrations that can be produced.

    b. A required notice of replacement must be presented, read to consumers, and signed by the producer and consumer.

2. The regulation lists illustrative violations, and establishes penalties that may include the revocation or suspension of a producer's or company's license, monetary fines, and forfeiture of commissions or compensation. Commissioners may require insurers to make

restitution, and restore policy values with interest when violation are material to the sale. [*See*, Section 8 of the regulation].

C. Overview of Issue

1. A replacement occurs when an individual uses existing life insurance policy or annuity contract values to purchase a new policy or contract.

2. A replacement may involve the use of the entire value of an existing policy or contract, as in the case of a surrender, or it may involve the use of only a portion of the existing values.

3. Under the NAIC Model as amended in 2000, the use of *any* portion of the values of an existing policy or contract to purchase a new policy or contract constitutes replacement, including borrowing, assigning dividends, lapsing, or forfeiting.

    a. External replacement occurs when a company replaces the life or annuity product of another company.

    b. Internal replacement occurs when a company replaces a life or annuity contract that it has already issued.

D. *Purpose* of the Amended NAIC Replacement Regulation

1. To regulate the activities of insurers and producers with respect to the replacement of existing life insurance and annuities.

2. To protect the interests of life insurance and annuity purchasers by establishing minimum standards of conduct to be observed in replacement or financed purchase transactions, and to:

    a. Assure that purchasers receive information with which a decision can be made in his or her own best interest;

    b. Reduce the opportunity for misrepresentation and incomplete disclosure; and

    c. Establish penalties for failure to comply with the regulation.

E. Regulation *Applies to Variable Life Insurance and Variable Annuity Replacements*

1. The term *replacement* is defined in the regulation to mean a transaction in which a new policy or contract is to be purchased, and it is known or should be known to the proposing producer, or to the proposing insurer if there is no producer, that by reason of the transaction, an existing policy or contract has been or is to be:

    a. Lapsed, forfeited, surrendered or partially surrendered,

assigned to the replacing insurer or otherwise terminated;

b. Converted to reduced paid-up insurance, continued as extended term insurance, or otherwise reduced in value by the use of nonforfeiture benefits or other policy values;

c. Amended so as to effect either a reduction in force of for which benefits would be paid;

d. Reissued with any reduction in cash value; or

e. Used in a financed purchase.

2. The regulation excuses variable life and variable annuity contracts from requirements in Sections 5(A)(2) and 6(B) to provide illustrations or policy summaries.

    a. In place of the policy summaries and illustrations requirement, the regulation mandates "premium or contract distribution amounts and identification of the appropriate prospectus or offering circular" instead.

    b. In all other respects, the regulation fully applies to individual variable contract replacements.

F. *Exceptions* from regulation for group contracts

1. The regulation does not apply to transactions involving:

    a. Policies or contracts used to fund:

        (1) An employee pension or welfare benefit plan that is covered by the Employee Retirement and Income Security Act (ERISA);

        (2) A plan described by Sections 401(a), 401(k) or 403(b) of the Internal Revenue Code, where the plan, for purposes of ERISA, is established or maintained by an employer;

        (3) A governmental or church plan defined in Section 414, a governmental or church welfare benefit plan, or a deferred compensation plan of a state or local government or tax exempt organization under Section 457 of the Internal Revenue Code; or

        (4) A non-qualified deferred compensation arrangement established or maintained by an employer or plan sponsor.

    b. Group life insurance or group annuities where there is no

direct solicitation of individuals by an insurance producer.

c. Credit life insurance.

G. Duties of Producers and Insurers in Replacement Transactions

1. Duties of insurers that use producers [Section 4.]

a. Under the regulation, each insurer must:

(1) *Maintain a system of supervision and control* to insure compliance with the requirements of this regulation that shall *include at least* the following:

(a) *Inform its producers of the requirements of the regulation* and incorporate the requirements of the regulation into all relevant *producer training manuals* prepared by the insurer;

(b) *Provide* to each producer *a written statement of the company's position with respect to the acceptability of replacements* providing guidance to its producer as to the appropriateness of these transactions;

(c) *A system to review the appropriateness* of each replacement transaction *that the producer does not indicate is in accord with the regulation's standards;*

(d) Procedures to *confirm* that the *requirements* of this regulation have been *met*; and

(e) Procedures to *detect transactions that are replacements of existing policies* or contracts by the existing insurer, but that have not been identified as such by the applicant or producer.

(2) *Have the capacity to produce*, upon request, and make available to the Insurance Department, *records of each producer's*:

(a) *Replacements*, including financed purchases, as a percentage of the producer's total annual sales for life insurance and annuity contracts not exempted from this regulation;

(b) *Number of lapses* of policies and contracts

by the producer as a percentage of the producer's total annual sales for life insurance and annuity contracts not exempted from this regulation;

(c) Number of transactions that are *unidentified replacements of existing policies* or contracts by the existing insurer detected by the company's monitoring system as required by Section (4)(A)(5) of the regulation; and

(d) *Replacements, indexed by replacing producer and existing insurer*.

(3) Require with or as a part of each application for life insurance or an annuity a signed statement by both the applicant and the producer as to whether the applicant has existing policies or contracts;

(4) Require with each application for life insurance or an annuity that indicates an existing policy or contract a completed notice regarding replacements as contained in Attachment 1 to the regulation;

(5) When the applicant has existing policies or contracts, retain completed and signed copies of the notice regarding replacements in its home or regional office for at least five years after the termination or expiration of the proposed policy or contract;

(6) When the applicant has existing policies or contracts, obtain and retain copies of any sales material as required by Section 3(E) of the regulation, the basic illustration and any supplemental illustrations used in the sale and the producer's and applicant's signed statements with respect to financing and replacement in its home or regional office for at least five years after the termination or expiration of the proposed policy or contract

(7) Records required to be retained by the regulation may be maintained in paper, photograph, microprocess, magnetic, mechanical or electronic media or by any process which accurately reproduces the actual document.

2. Duties of Replacing Insurers that Use Producers [Section 6].

a. Where a replacement is involved in the transaction, the replacing insurer shall:

(1) Verify that the required forms are received and are in compliance with the regulation;

(2) Notify any other existing insurer that may be affected by the proposed replacement within five business days of receipt of a completed application indicating replacement or when the replacement is identified if not indicated on the application, and mail a copy of the available *illustration or policy summary* for the proposed policy or available disclosure document for the proposed contract within five business days of a request from an existing insurer; [*note*: this illustration and policy summary requirement does not apply to variable contracts.]

(3) Be able to produce copies of the notification regarding replacement required in Section 4(B), *indexed by producer, in its home or regional office* for at least five years or until the next regular examination by the insurance department of a company's state of domicile, whichever is later; and

(4) Provide to the policy or contract owner notice of the right to return the policy or contract within thirty (30) days of the delivery of the contract and receive an unconditional full refund of all premiums or considerations paid on it, including any policy fees or charges or, in the case of a *variable or market value adjustment policy or contract*, a payment of the cash surrender value provided under the policy or contract plus the fees and other charges deducted from the gross premiums or considerations or imposed under such policy or contract.

b. In transactions where the replacing insurer and the existing insurer are the same or subsidiaries or affiliates under common ownership or control [*internal replacements*] allow credit for the period of time that has elapsed under the replaced policy's or contract's incontestability and suicide period up to the face amount of the existing policy or contract. With regard to *financed purchases* the credit may be limited to the amount the face amount of the existing policy is reduced by the use of existing policy values to fund the new policy or contract.

c. If an insurer *prohibits the use of sales material other than that approved* by the company, as an alternative to the requirements of Section 3(E) the insurer may:

(1) Require with each application a statement *signed by the producer* that:

- Represents that the producer used only company approved sales material;
- *Lists*, by identifying number or other descriptive language, the *sales material that was used*; and
- States that copies of all sales material were left with the applicant in accordance with Section 3(D); and

- Within ten days of the issuance of the policy or contract:

  (a) Notify the applicant by sending a letter or by verbal communication with the applicant *by a person whose duties are **separate from the marketing area** of the insurer*, that the producer has represented that copies of all sales material have been left with the applicant in accordance with Section 3(D);

  (b) Provide the applicant with a *toll free number* to contact *company personnel involved in the compliance function* if such is not the case; and

  (c) Stress the importance of retaining copies of the sales material for future reference; and

- Keep a copy of the letter or other verification in the policy file at the home or regional office for at least five years after the termination or expiration of the policy or contract.

3. Duties of the Existing Insurer [Section 6].

a. Where a replacement is involved in the transaction, the existing insurer shall:

(1) Upon notice that its existing policy or contract may be replaced or a policy may be part of a financed purchase, *retain copies* of the notification in its home or regional office, *indexed by replacing insurer*, notifying it of the

replacement for at least five years or until the conclusion of the next regular examination conducted by the Insurance Department of its state of domicile, whichever is later.

(2) Send a letter to the policy or contract owner of the right to receive information regarding the existing policy or contract values including, if available, an in force illustration or policy summary if an in force illustration cannot be produced within five business days of receipt of a notice that an existing policy or contract is being replaced. The information shall be provided within five business days of receipt of the request from the policy or contract owner.

(3) Upon receipt of a request to borrow, surrender or withdraw any policy or contract values, send to the applicant a notice, advising the policy or contract owner of the effect release of policy or contract values will have on the non-guaranteed elements, face amount or surrender value of the policy or contract from which the values are released. The notice shall be sent separate from the check if the check is sent to anyone other than the policy or contract owner. In the case of *consecutive automatic premium loans or systematic withdrawals* from a contract, the insurer is only required to send the notice at the time of the first loan or withdrawal.

4. Duties of Producers [Section 4].

   a. A producer who initiates an application must submit to the insurer, with or as part of the application, a statement signed by both the applicant and the producer as to whether the applicant has existing policies or contracts. If the answer is "no," the producer's duties with respect to replacement are complete.

   b. If the applicant answered "yes" to the question regarding existing coverage referred to in Subsection (A), the producer shall present and read to the applicant, not later than at the time of taking the application, a notice regarding replacements in the form as described in Attachment 1 to the regulation or other substantially similar form approved by the commissioner. *The notice shall be signed by both the applicant and the producer* attesting that the notice has been read aloud by the producer or that the applicant did not wish the notice to be read aloud (in which case the producer need not have read the notice aloud) and left with the applicant.

   c. The notice shall list all life insurance policies or annuities

proposed to be replaced, properly identified by name of insurer, the insured or annuitant, and policy or contract number if available; and shall include a statement as to whether each policy or contract will be replaced or whether a policy will be used as a source of financing for the new policy or contract. If a policy or contract number has not been issued by the existing insurer, alternative identification, such as an application or receipt number, shall be listed.

d. In connection with a replacement transaction *the producer shall leave with the applicant* at the time an application for a new policy or contract is completed *the original or a copy of all sales material*. With respect to electronically presented sales material, it shall be provided to the policyholder in printed form no later than at the time of policy or contract delivery.

e. Except as provided in Section 5(C) of the regulation, in connection with a replacement transaction the producer shall submit to the insurer to which an application for a policy or contract is presented, a copy of each document required by this section, *a statement identifying any preprinted or electronically presented company approved sales materials used*, and *copies of any individualized sales materials*, including *any illustrations* used in the transaction

H. Selected Definitions

1. Section 2(D) defines the term *financed purchase* as "the purchase of a new policy involving the actual or intended use of funds obtained by the withdrawal or surrender of, or by borrowing from values of an existing policy to pay all or part of any premium due on the new policy."

   a. If a withdrawal, surrender, or borrowing involving the policy values of an existing policy are used to pay premiums on a new policy owned by the same policyholder *within thirteen months before or after the effective date of the new policy* and is known by the replacing insurer, or if the withdrawal, surrender, or borrowing is shown on any illustration of the existing and new policies made available to the prospective policyowner by the insurer or its producers, it will be *deemed prima facie evidence of a financed purchase.*

2. Section 2(I) defines the term registered contract as "a variable annuity contract or variable life insurance policy subject to the prospectus delivery requirements of the Securities Act of 1933."

I. Several aspects of the amended NAIC model regulation parallel SEC and FINRA positions concerning Section 1035 exchanges and bonus annuity sales.

1. Selected list of parallel regulatory concepts

    a. FINRA Guideline on Variable Life Insurance Distribution: NTM 00-44 (June 2000).

    b. FINRA Guidelines on Supervisory Responsibilities: NTM 99-45 (June 1999).

    c. FINRA Statement on Variable Annuity Distribution: NTM 99-35 (May 1999).

    d. SEC Office of Compliance Inspections and Examinations: Indicators of "Good" Internal Controls in Variable Contract Distribution.

        (1) A compilation of the SEC's indicators drawn from speeches and seminar comments is discussed in Wilkerson, *Variable Product Distribution: A Continuing Study of Compliance Examinations, Inspections Sweeps and Evolving Regulatory Standards*, ACLI Compliance Section Annual Meeting (July 19, 2000) at 20.

    e. SEC Examination of Variable Annuity "Bonus" Programs

        (1) Several of the items requested in the SEC's inspection letter requested documents and information that the amended NAIC Model Replacement Regulation also addresses.

            (a) Scope of documents requested in the SEC's examinations was outlined in *Variable Product Distribution: A Continuing Study of Compliance Examinations, Inspections Sweeps and Evolving Regulatory Standards*, ACLI Compliance Section Annual Meeting (July 19, 2000) at 6.

    a. FINRA and SEC inspection sweeps focusing on "Section 1035 exchanges" of variable contracts and "life financing" arrangements (1998 and 1996.)

        (1) These sweeps and the documentation they elicited were discussed in *Variable Product Distribution: A Continuing Study of Compliance Examinations, Inspections Sweeps and Evolving Regulatory Standards*, ACLI Compliance Section Annual Meeting (July 19, 2000) at 11 and 15.

Attachment 1 to this Outline on the Model Replacement Regulation

IMPORTANT NOTICE: REPLACEMENT OF LIFE INSURANCE OR ANNUITIES

This document must be signed by the applicant and the producer, if there is one, and a copy left with the applicant.

You are contemplating the purchase of a life insurance policy or annuity contract. In some cases this purchase may involve discontinuing or changing an existing policy or contract. If so, a replacement is occurring. Financed purchases are also considered replacements.

A replacement occurs when a new policy or contract is purchased and, in connection with the sale, you discontinue making premium payments on the existing policy or contract, or an existing policy or contract is surrendered, forfeited, assigned to the replacing insurer, or otherwise terminated or used in a financed purchase.

A financed purchase occurs when the purchase of a new life insurance policy involves the use of funds obtained by the withdrawal or surrender of or by borrowing some or all of the policy values, including accumulated dividends, of an existing policy, to pay all or part of any premium or payment due on the new policy. A financed purchase is a replacement.

You should carefully consider whether a replacement is in your best interests. You will pay acquisition costs and there may be surrender costs deducted from your policy or contract. You may be able to make changes to your existing policy or contract to meet your insurance needs at less cost. A financed purchase will reduce the value of your existing policy or contract and may reduce the amount paid upon the death of the insured.

We want you to understand the effects of replacements before you make your purchase decision and ask that you answer the following questions and consider the questions on the back of this form.
1. Are you considering discontinuing making premium payments, surrendering, forfeiting, assigning to the insurer, or otherwise terminating your existing policy or contract? ___ YES ___ NO

2. Are you considering using funds from your existing policies or contracts to pay premiums due on the new policy or contract? ___ YES ___ NO

If you answered "yes" to either of the above questions, list each existing policy or contract you are contemplating replacing (include the name of the insurer, the insured, and the contract number if available) and whether each policy will be replaced or used as a source of financing:

INSURER NAME
CONTRACT OR POLICY#
INSURED OR ANNUITANT: REPLACED (R) OR FINANCING (F)

1.

2.

3.

Make sure you know the facts. Contact your existing company or its agent for information about the old policy or contract. [If you request one, an in force illustration, policy summary or available disclosure documents must be sent to you by the existing insurer.] Ask for and retain all sales material used by the agent in the sales presentation. Be sure that you are making an informed decision.

The existing policy or contract is being replaced because ______________________
____.

I certify that the responses herein are, to the best of my knowledge, accurate:

____

Applicant's Signature and Printed Name   Date

____   _______________

Producer's Signature and Printed Name   Date

____   _______________

I do not want this notice read aloud to me. ___________ (Applicants must initial only if they do not want the notice read aloud.)

A replacement may not be in your best interest, or your decision could be a good one. You should make a careful comparison of the costs and benefits of your existing policy or contract and the proposed policy or contract. One way to do this is to ask the company or agent that sold you your existing policy or contract to provide you with information concerning your existing policy or contract. This may include an illustration of how your existing policy or contract is working now and how it would perform in the future based on certain assumptions. Illustrations should not, however, be used as a sole basis to compare policies or contracts. You should discuss the following with your agent to determine whether replacement or financing your purchase makes sense:

PREMIUMS: Are they affordable?
Could they change?
You're older--are premiums higher for the proposed new policy?
How long will you have to pay premiums on the new policy? On the old policy?

POLICY VALUES: New policies usually take longer to build cash values and to pay dividends.
Acquisition costs for the old policy may have been paid, you will incur costs for the new one.
What surrender charges do the policies have?
What expense and sales charges will you pay on the new policy?
Does the new policy provide more insurance coverage?

INSURABILITY: If your health has changed since you bought your old policy, the new one could cost you more, or you could be turned down.
You may need a medical exam for a new policy.
Claims on most new policies for up to the first two years can be denied based on inaccurate statements.
Suicide limitations may begin anew on the new coverage.

IF YOU ARE KEEPING THE OLD POLICY AS WELL AS THE NEW POLICY:

How are premiums for both policies being paid?
How will the premiums on your existing policy be affected?
Will a loan be deducted from death benefits?
What values from the old policy are being used to pay premiums?

IF YOU ARE SURRENDERING AN ANNUITY OR INTEREST SENSITIVE LIFE PRODUCT:

Will you pay surrender charges on your old contract?
What are the interest rate guarantees for the new contract?
Have you compared the contract charges or other policy expenses?

OTHER ISSUES TO CONSIDER FOR ALL TRANSACTIONS:

What are the tax consequences of buying the new policy?
Is this a tax free exchange? (See your tax advisor.)
Is there a benefit from favorable "grandfathered" treatment of the old policy under the federal tax code?
Will the existing insurer be willing to modify the old policy?

How does the quality and financial stability of the new company compare with your existing company?

(Attachment 2 to Replacement Outline)

NOTICE REGARDING REPLACEMENT
REPLACING YOUR LIFE INSURANCE POLICY OR ANNUITY?

Are you thinking about buying a new life insurance policy or annuity and discontinuing or changing an existing one? If you are, your decision could be a good one--or a mistake. You will not know for sure unless you make a careful comparison of your existing benefits and the proposed policy or contract's benefits.

Make sure you understand the facts. You should ask the company or agent that sold you your existing policy or contract to give you information about it.

Hear both sides before you decide. This way you can be sure you are making a decision that is in your best interest.

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NAIC Model Regulation on the Use of Senior-Specific Certifications and Professional Designations in the Sale of Life Insurance and Annuities

Carl B. Wilkerson, Vice President & Chief Counsel-Securities & Litigation American Council of Life Insurers © 2017 All Rights Reserved.

I. NAIC Model Regulation on the Use of Senior-Specific Certifications and Professional Designations in the Sale of Life Insurance and Annuities.

A. This NAIC regulation directly parallels the North American Securities Administrators Association (NASAA) credentialing regulations and was developed in close coordination with NASAA and supported by NASAA.

B. See http://www.nasaa.org/content/Files/Senior_Model_Rule110807.pdf

C. The NAIC regulation and an accompanying bulleting can be obtained on the NAIC website at http://www.naic.org/Releases/2008_docs/senior_sales.htm .

II. Purpose of the NAIC Regulation

A. The regulation establishes standards to protect consumers from misleading and fraudulent marketing practices with respect to the use of senior-specific certifications and professional designations in the solicitation, sale or purchase of, or advice made in connection with, a life insurance or annuity product.

B. The regulation will apply to any solicitation, sale or purchase of, or advice made in connection with, a life insurance or annuity product by an "insurance producer," that is defined as a person required to be licensed under the laws of this State to sell, solicit or negotiate insurance, including annuities.

III. Prohibited Uses of Senior-Specific Certifications and Professional Designations [Section 5]

A. Under the regulation, it will be an unfair and deceptive act or practice in the business of insurance within the meaning of the Unfair Trade Practices Act for an insurance producer to use a senior-specific certification or professional designation that indicates or implies in such a way as to mislead a purchaser or prospective purchaser that insurance producer has special certification or training in advising or servicing seniors in connection with the solicitation, sale or purchase of a life insurance or annuity product or in the provision of advice as to the value of or the advisability of purchasing or selling a life insurance or annuity product, either directly or indirectly through publications or writings, or by issuing or promulgating analyses or reports related to a life insurance or annuity product.

B. The prohibited use of senior-specific certifications or professional designations includes, but is not limited to, the following:

1. Use of a certification or professional designation by an insurance producer who has not actually earned or is otherwise ineligible to use such certification or designation;

2. Use of a nonexistent or self-conferred certification or professional designation;

3. Use of a certification or professional designation that indicates or implies a level of occupational qualifications obtained through education, training or experience that the insurance producer using the certification or designation does not have; and

4. Use of a certification or professional designation that was obtained from a certifying or designating organization that:

   a) Is primarily engaged in the business of instruction in sales or marketing;

   b) Does not have reasonable standards or procedures for assuring the competency of its certificants or designees;

   c) Does not have reasonable standards or procedures for monitoring and disciplining its certificants or designees for improper or unethical conduct; or

   d) Does not have reasonable continuing education requirements for its certificants or designees in order to maintain the certificate or designation.

5. Under the regulation, there is a rebuttable presumption that a certifying or designating organization is not disqualified solely for purposes of subsection A(2)(d) when the certification or designation issued from the organization does not primarily apply to sales or marketing and when the organization or the certification or designation in question has been accredited by:

   a) The American National Standards Institute (ANSI);

   b) The National Commission for Certifying Agencies; or

   c) Any organization that is on the U.S. Department of Education's list entitled "Accrediting Agencies Recognized for Title IV Purposes."

6. In determining whether a combination of words or an acronym standing for a combination of words constitutes a certification or

professional designation indicating or implying that a person has special certification or training in advising or servicing seniors, factors to be considered shall include:

a) Use of one or more words such as “senior,” “retirement,” “elder,” or like words combined with one or more words such as “certified,” “registered,” “chartered,” “advisor,” “specialist,” “consultant,” “planner,” or like words, in the name of the certification or professional designation; and

b) The manner in which those words are combined.

7. For purposes of this NAIC regulation, a job title within an organization that is licensed or registered by a State or federal financial services regulatory agency is not a certification or professional designation, unless it is used in a manner that would confuse or mislead a reasonable consumer, when the job title:

a) Indicates seniority or standing within the organization; or

b) Specifies an individual’s area of specialization within the organization.

8. Under this subsection, financial services regulatory agency includes, but is not limited to, an agency that regulates insurers, insurance producers, broker-dealers, investment advisers, or investment companies as defined under the Investment Company Act of 1940.

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The Impact of State Insurance Consulting Laws and Related Provisions on Insurance Producers Performing Financial Planning Services

Carl B. Wilkerson, Vice President & Chief Counsel-Securities & Litigation
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I. The Impact of State Insurance Consulting Laws and Related Provisions on Insurance Producers Performing Financial Planning Services

A. Background

1. A degree of variability exists in state insurance statutes and regulations concerning financial planning by life insurance agents.

2. Careful review of the various state laws and regulations is valuable in confirming proper procedures and activities.

B. NAIC Unfair Trade Practices Act provisions governing financial planning:

1. §2(M) of the NAIC Unfair Trade Practices Act defines an unfair financial planning practice by an insurance producer to be:

a) Holding himself or herself out directly or indirectly to the public as they "financial planner," "investment advisor," "consulted," "financial counselor," or any other specialists engaged in the business of giving financial planning for advice relating to investments, insurance, real estate tax matters or trust and estate matters when such person is in fact engaged only in the sale of policies.

b) Engaging in the business of financial planning without disclosing to the client prior to the execution of the agreement provided for in paragraph 3 [of this regulation], or solicitation of the sale of a product or service that:

(1) He or she is also an insurance salesperson, and

(2) That a commission for the sale of the insurance products will be received in addition to a fee for financial planning, if such is the case.

c) This NAIC provision forbids fees other than commission for financial planning by insurance producers, unless such fees are based upon a written agreement, signed by the client in advance; a copy of the agreement must be given to the client at the time it is signed.

C. Insurance Consulting Laws

1. Many states have adopted statutes or regulations generally referred to as "insurance consulting" provisions that seek to protect insurance product policyholders by preventing the receipt of insurance commissions and insurance consulting fees concerning the same sale.

2. It is unlikely that this body of law was intended to govern broad-spectrum of financial planning conducted by insurance agents in today's market. Nonetheless, financial planning and investment advisory activities could inadvertently trigger the scope and terms of the insurance consulting laws.

a) Insurance consulting laws evolved to address problems of a traditional life insurance environment, not more recent developments such as financial planning for investment advice.

b) While the application of the insurance consulting laws to financial planning is not clear, potential coverage could be triggered in two ways:

(1) Fee and commission financial planning arrangements that also involve a recommendation and ultimate purchase of insurance product;

(2) Commission only financial planning arrangements that involve the recommendation and ultimate purchase of an insurance product.

c) Insurance consulting laws generally fall into two categories:

(1) States prohibiting insurance agents from receiving both consulting fees and sales commissions in connection with the same assurance product sale.

(a) See, e.g., Connecticut Insurance Code §38 – 92h (an individual serving as a quote certified insurance consultant" is prohibited from receiving both sales commission and a consultant's commission in connection with the sale of insurance).

(2) States permitting insurance agents to obtain both consulting fees and sales commissions in connection with the same insurance product sale, providing clear

disclosure about the joint receipt of a fee and commission is communicated.

(a) See, e.g., Arkansas Insurance Department Bulletin No. 1185 (May 10, 1985): "the obvious intent of this section [§66 -- 3023 (3)] is to permit genuine utilization of the [property/casualty and life/disability] agent's expertise, for compensation, but to require proper disclosure to the client and to prevent price gouging by unscrupulous persons."

(b) See also, New Mexico Insurance Rule 80-3-6 (c) which states that "terms such as financial planner, investment advice or, financial consultant, or financial counseling shall not be used in such a way as to imply that the insurance agent is generally engaged in an advisory business in which compensation is unrelated to sales, unless such is actually the case.

(3) A compilation of state laws and regulations about insurance consulting laws and investment advisor provisions is set forth below.

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A Comprehensive System of State Regulation Governs

the Distribution of Insurance and Annuity Contracts

Carl B. Wilkerson, Vice President & Chief Counsel-Securities & Litigation
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A. State Insurance Regulation

Through a network of statutes and regulations, state insurance departments heavily regulate the operations, products, and sales of life insurance companies. Life insurers and their salespersons must satisfy this regulatory structure in their state of domicile and every jurisdiction in which they distribute life insurance and annuities. Uniformity of regulation is accomplished throughout the states by means of model statutes and regulations promulgated by the National Association of Insurance Commissioners (the "NAIC"). Many of the insurance statutes and regulations promulgated and enforced by state insurance departments fulfill regulatory goals quite similar to those of the state securities administrators. The summary below highlights the broad scope and comprehensiveness of certain state insurance statutes and regulations. While only a small portion of the larger universe of state insurance regulation, this regulations are directly relevant in evaluating the market conduct structure governing insurance salespersons engaged in the delivery of financial planning and broker-dealer services. This discussion is intended to fill in other areas not covered in the preceding outline materials to this submission.

B. Unfair Trade Practices

Virtually every state has enacted a version of the NAIC Model Unfair Trade Fair Practices Act which was developed to regulate trade practices in the insurance business by defining and prohibiting practices that constitute unfair methods of competition or unfair deceptive acts or practices.[1]

A variety of the activities defined to be unfair trade practices directly parallel the purpose and scope of state securities codes. Section 4(A) involves misrepresentations and false advertising of insurance policies, and identifies unfair trade practices to include any estimate, illustration, circular or statement, sales misrepresentation, omission or comparison that misrepresents the benefits, advantages, conditions or terms of any policy, among other things.

Section 4(B) involves false information and advertising generally. This provision defines an unfair trade practice to include making, publishing or disseminating in a newspaper, magazine or other publication, on any radio/television station any assertion,

[1]This model statute governs items previously subject to Section 5 of The Federal Trade Commission Act. Congress observed that continued regulation of insurance by the states was in the public interest. *See*, legislative history of NAIC Unfair Trade Practices Act, NAIC Model Regulation Service at 880-20(1993).

representation or statement about an insurer or its business, which is untrue, deceptive or misleading.

Knowingly making any false statement of any material fact to insurance regulators, or in documents that will be publicly disseminated, is defined to be an unfair trade practice in Section 4(B) of the Model Unfair Trade Practices Act. This proscription is consistent with the truthfulness and accuracy of reports, records and representations required of Broker/Dealers by the NASD and the SEC under the federal securities laws.

Section 4(J) involves the failure to maintain marketing and performance records, and defines as an unfair trade practice the failure of an insurer to maintain its books, records, documents, and other business records in such an order that data regarding complaints, claims, reading, underwriting and marketing are accessible and retrievable for examination by the insurance commissioner. Data for at least the current calendar year in the two preceding years must be maintained under this standard. This provision directly parallels the scope and purpose of NASD Conduct Rule 3110 regarding books and records.

Section 4(K) defines the failure of any insurer to maintain a complete record of all the complaints it received since the date of its last market conduct examination to be an unfair trade practice. The records of complaints must indicate the total number of complaints, their classification by line of insurance, the nature of each complaint, the disposition of each complaint and the time it took to process each.[2] For purposes of this subsection, the term "complaint" means any written communication primarily expressing a grievance.

Like state securities administrators, insurance commissioners have the power to examine and investigate the affairs of every insurer operating in the insurance department's state "in order to determine whether such insurer has been or is engaged in any unfair trade practice prohibited by [the Unfair Trade Practices Act]."[3] Several provisions embellish this important authority.

For example, Section 7 of the Unfair Trade Practices Act gives insurance commissioners extensive authority to initiate hearings concerning unfair trade practices, to compel witnesses, appearances, production of books, and service of process. Section 7 sets forth detailed administrative and procedural practices, in order to assure due process and quasi-judicial formality.

Section 8 of the Unfair Trade Practices statute authorizes insurance commissioners finding insurers guilty of unfair trade practices to issue written findings and enforcement orders requiring the insurer to cease and desist from engaging in the act or practice. The insurance commissioner also has the discretionary authority to suspend and revoke

[2]The NAIC has also promulgated a Model Regulation for Complete Records to be maintained pursuant to Section 4(K) of the NAIC Unfair Trade Practices Act. *See*, NAIC Model Regulation Service at 844-1(1992).This regulation sets forth a complaint record form, content requirements, maintenance requirements, and standards concerning the format of complaint records.

[3] *See* Section 6, Power of Commissioner, Model Unfair Trade Practices Act, NAIC Model Regulation Service at 880-9(1993).

the insurer's license if the insurer knew or reasonably should have known that its conduct violated the Unfair Trade Practices Act, and to order penalties of $1,000 for each violation up to an aggregate penalty of $100,000, unless the violation was committed flagrantly in conscious disregard of the act, in which case the penalty may be up to $25,000 for each violation to an aggregate total penalty of $250,000. A similar monetary violation may be imposed under Section 11 for violations of cease and desist orders. The act also provides for judicial review of insurance commissioner orders and authorizes immunity from prosecution for witnesses who attend, testify or produce books, records or other paper correspondence.[4]

These significant powers that may be used by insurance commissioners to enforce violations of unfair trade practice proscriptions, together with the recordkeeping, reporting and inspection powers of the Act, provide a package of regulatory tools directly analogous to state securities codes, the NASD Rules of Conduct and SEC regulations governing market conduct practices and the prosecution of violations. In a sum, the unfair trade practice laws provide meaningful proscriptions that eliminate the need for duplicative regulation of variable contracts.

C. NAIC Model Fraud Laws and Fraud Legislation

Enactment of state fraud statutes represents another significant insurance regulatory development. Recent market conduct issues have resulted in some insurance departments requiring insurer management to assume increased responsibility for supervision of sales activities. Other states have taken an approach similar to that of New York and Pennsylvania by requiring insurer review of market conduct compliance, thus placing direct responsibility at the corporate officer level. This widespread action dovetails with the objectives of the Federal Crime Control Statute and the Federal Sentencing guidelines, discussed below.

While states have taken different approaches to the issue, the majority of states addressing the fraud issue enacted legislation similar to the NAIC Model Fraud Laws.[5]

D. Market Conduct Examinations

Nearly every jurisdiction has enacted a version of the NAIC Model Law on Examinations.[6] This Act is designed to provide an effective and efficient system for examining the activities, operations, financial condition and affairs of all persons transacting the business of insurance in each state and concerning individuals otherwise subject to the insurance commissioner's jurisdiction. The Act is intended to enable commissioners to adopt a flexible system of examinations and allocate resources deemed appropriate and necessary for the administration of the insurance laws of each state. The Model Law on Examinations sets forth standards for the conduct of

[4]*See* Sections 8, 9, 10, 11 and 14 of the Model Unfair Trade Practices Act, NAIC Model Regulation Service at 880-10 through 13(1994).

[5]*See* NAIC Insurance Fraud Prevention Model Act, NAIC Model Reporting Service at 680-1(1995).

[6]*See* NAIC Model Regulation Service at 390-1(1991).

examinations, commissioner authority, scope, and scheduling of examinations. It also details the scope of examination reports which shall be comprised of only facts appearing on books, records or other documents of the company, its agents or other persons examined or as ascertained from the testimony of its officers or agents or other persons examined.[7]

Significantly, this Model Act dovetails with the NAIC Market Conduct Examiner's Handbook, an extremely detailed manual for examiners to assure that examiners follow comprehensive, uniform practices and procedures. The Examiner's Handbook is divided into seven different sections and contains 58 different standards. Among other things, the Examiner's Handbook addresses complaint handling, marketing and sales, producer licensing, and company operations/management.[8]

[7] *See* Sections 3, 4, and 5 of the Model Law on Examinations, NAIC Model Regulation Service at 390-5 (1991). Section 5 also sets forth detailed provisions for orders and administrative procedures in the conduct of hearing and adoption of a report on examination.

[8] Certain standards under the complaint handling section illuminate the depth and scope of the market conduct examination. Several standards are set forth below in this note as representative examples.

Complaint Handling**-Standard 2**

The company has adequate complaint handling procedures in place and communicates such procedures to policyholders.

Review Procedures and Criteria

Review manuals to verify complaint procedures exist. Procedures in place should be sufficient to require satisfactory handling of complaints received as well as internal procedures for analysis in areas developing complaints. There should be a method for distribution of and obtaining and recording response to complaints. This method should be sufficient to allow response within the time frame required by state law.

Company should provide a telephone number and address for consumer inquiries.

Complaint Handling**-Standard 3**

The company should take adequate steps to finalize and dispose of the complaint in accordance with applicable statutes, rules and regulations and contract language.

Review Procedures and Criteria

Review complaints documentation to determine if the company response fully addresses the issues raise. If the company did not properly address/resolve the complaint, the examiner should ask company what corrective action it intends to take.

Commentary:

Reference to the examiner's general instructions on Handbook page VIII-14 (November 1995) reveals that an inquiry broader in scope than the mere resolution of a given complaint is expected. For example, the Handbook contains the following instructions: "The examiner should review the frequency of similar complaints and be aware of any pattern of specific type of complaints....Should the types of complaints generated be cause for unusual concern, specific measures should be instituted to investigate other areas of the company's operation."

Complaint Handling**-Standard 4**

Throughout most of 1995 and 1996, the NAIC significantly revised the Market Conduct Examiner's Handbook. The NAIC, together with industry input, sought to expand and enhance tools fostering the detection and prevention of marketplace abuse in the life insurance industry. Market conduct examinations are extremely comprehensive and serve as a means of positive reinforcement, by discouraging deficient practices that will be detected on examination, resulting in remedial action, and insurance department intervention.

E. Agents' Licensing and Testing

The NAIC Agents and Brokers Licensing Model Act,[9] which appears virtually in every state, governs the qualifications and procedures for licensing insurance and annuity agents and brokers. This model law sets forth examination and licensing standards in great detail, and has a specific category for variable annuities and variable life insurance contracts. Licensed salespeople must be deemed by the insurance commissioner to be competent, trustworthy, financially responsible, and of good personal and business reputation. Insurance brokers must also fulfill experience requirements. Section 8 of this regulation governs license denial, non-renewal and termination, giving the insurance commissioner broad discretion to suspend, revoke or refuse to issue or renew a license upon finding any of a variety of conditions including materially untrue statements, violation or noncompliance with insurance laws, withholding, misappropriating or converting customer moneys, conviction of a felony or misdemeanor involving moral turpitude, forgery, or cheating on licensing examinations, among other things.

F. Agent Investigation: Character and Background Investigation Requirements

Most jurisdictions require that insurance producer license applicants be competent, trustworthy, and of good moral character in order to obtain a license. However, some now expressly require appointing insurers to certify that they have investigated the applicant's character and background and have found the applicant to be qualified and worthy of a license. Similar to FINRA, some jurisdictions implement fingerprinting as part of the background check. Related to these requirements is the portion of the NAIC Producer Licensing Model Act that allows the commissioner to refuse to issue an insurance producer's license if the commissioner finds that the individual has committed any act that is a ground for denial, suspension or revocation of the license. A law survey on this topic appears at the end of this segment of the appendix.

G. Continuing Education for Agents and Brokers

In granting insurance agents and brokers licenses, most states also impose significant continuing education standards that parallel in objective and scope the continuing

The time frame within which the company responds is in accordance with applicable statutes, rules, and regulations.

Review Procedures and Criteria
Review complaints to ensure company is maintaining adequate documentation. Determine if the company response is timely. The examiner should refer to state laws for the required time frame.

[9] *See* NAIC Model Regulation Service at 210-1 (2008).

education standards recently developed by the securities industry together with the NASD. As in other areas seeking uniformity, the NAIC has promulgated the Agents and Brokers Licensing Model Act.[10] Under Section 5 of this model regulation, licensed agents must annually satisfy courses or programs of instruction approved by insurance commissioners in each state according to a minimum number of classroom hours, which typically is in the range of 25 class room hours per year for life and annuity salespersons. The courses include those presented by the Life Underwriter Training Council Life Course Curriculum, the American College's Chartered Life Underwriter and Chartered Financial Planner curriculum, and the Insurance Institute of America's programs in general insurance, for example. Like FINRA's initial and ongoing educational requirements for registered representatives, state insurance regulators understand that testing, licensing and demonstration of continued competence through continuing education is critically important in the distribution of insurance and annuity products. A law survey on this topic appears at the end of this segment of the appendix.

H. Variable Contract Statutes

Life insurance companies are authorized to issue separate accounts funding variable life insurance and annuity contracts upon fulfilling a variable contract statute in their domestic state, which typically follows the NAIC Model Variable Contract Law.[11] This NAIC model statute gives the insurance commissioner exclusive authority to regulate the issuance and sale of variable contracts and to issue rules and regulations appropriate to carry out the act's purpose. This model act and associated regulations that appear under state insurance law gives an additional, important measure of regulatory scrutiny and purchaser protection.

Collectively, the NAIC statutes and regulations provide a significant network of comprehensive regulation over many important aspects affecting the marketing and sale of variable contracts that closely reflect the purpose and scope of analogous concepts of securities regulation.

I. Insurance Producer Database

From a market conduct perspective, life insurers have committed to a single, industry-accessible national producer database to facilitate their ability to track pertinent information regarding licensed producers. Access to information having a bearing on the producer's background, qualifications and competency is a valuable tool to insurers in the employment/appointment screening process. Moreover, widespread availability of such information makes it more difficult for a producer with significant disciplinary history to continue illegal or unethical practices by "company jumping."

NIPR (National Insurance Producer Registry) is a non-profit affiliate of the National Association of Insurance Commissioners (NAIC). It was created in October 1996 to develop and operate a national repository for producer license information (PDB) and to establish a network to facilitate the electronic exchange of producer information.

[10] *See* NAIC Model Regulation Service at 215-1 (2015).

[11] *See* NAIC Model Regulation Service at 260-1 (2015).

The Producer Database (PDB) is an electronic database consisting of information relating to insurance agents and brokers (producers) accessible through the NIPR Gateway on a subscription basis through the Internet. Internet PDB links participating state regulatory licensing systems into one common system establishing a repository of producer information. Internet PDB also contains or references producer information from sources such as the Regulatory Information Retrieval System (RIRS) of the NAIC. Its development is based, in part, on the belief that the widespread availability of such information will make it more difficult for a producer with significant disciplinary history to continue illegal or unethical practices.

The NIPR Gateway is an electronic communication network that links state insurance regulators with the entities they regulate to facilitate the electronic exchange of producer information; including license applications, appointments, and terminations. To date, data standards have been developed for the exchange of appointment and not-for-cause termination information. All data flowing through the NIPR Gateway will conform to these standards.

Through Internet PDB, industry is able to access all public information related to a producer provided by participating states, including licensing, demographics and final regulatory actions. The product is designed to assist insurers in exercising due diligence in the monitoring of agents and brokers to reduce the incidence of fraud. Currently, Internet PDB contains information on over 2.9 million producers. Information available includes:

- Demographics-name, date of birth, addresses
- License Summary-state of license, license number, issue date, expiration date, license type/class, residency, lines of authority, status, status reason, status/reason effective date.
- Continuing Education-CE compliance indicator, CE renewal date, CE credits needed.
- Certificates and Clearance-date issued, issuing state, receiving state, certification or clearance indicator.
- Regulatory Actions-State of action, entity role, origin of action, reason for action, enter date penalty/fine/forfeiture, effective date, file reference, time/length of dates.
- Appointment Information-Effective date, termination date, reasons for termination.

Currently all 50 states, DC and PR participate in the PDB.

In many respects, this producer data base parallels the purpose and scope of FINRA's Central Records Depository or CRD. Through the NIPR data base, problem producers can be tracked and deterred from the insurance business.

The NAIC Buyer’s Guide for Deferred Annuities provides plain-English, streamlined, simplified disclosure about fixed, variable and index annuities that allows apples to apples comparisons essential to informed purchase decisions. It contains a valuable list of core questions that consumers should ask salesperson when considering an annuity. The Buyer’s Guide is not attached to this Appendix because of its digital size. We recommend clicking through the above link to fully visualize the valuable content, readability, and its use of white space and color.