COMPLIANCE & ETHICS FORUM FOR LIFE INSURERS

# 2012 CEFLI Annuity Suitability Benchmarking Survey Executive Summary

## Introduction

CEFLI was asked recently by members of its Compliance & Ethics Committee to conduct a benchmarking survey to gauge the current state of life insurance industry practices with respect to annuity suitability. To conduct this analysis, a series of questions pertaining to annuity suitability practices was developed in conjunction with members of CEFLI's Annuity Suitability Working Group. These questions were presented to respondents to CEFLI's Annuity Suitability Benchmarking Survey (the "Survey"). This Report outlines the key findings of responses to the Survey.

## Purpose and Background

The purpose of this Survey was to determine the current state of life insurance industry practices with respect to annuity suitability.  Interest in these issues has grown in prominence during the past few years in light of the continuing evolution of suitability standards applicable to the sale of registered products (i.e., variable annuities) and non-registered products (i.e., fixed and indexed annuities).

The life insurance industry has been addressing suitability requirements for decades. Life insurers distributing variable annuity products through affiliated and unaffiliated broker-dealers had to demonstrate compliance with former National Association of Securities Dealers ("NASD") Rule 2310 pertaining to suitability and, in some instances, the former New York Stock Exchange ("NYSE") Rule 405 "Know Your Customer" that impacted suitability analysis for NYSE broker-dealer firms.

### NAIC Model Regulations:  NAIC Senior Protection in Annuity Transactions Model Regulation and the NAIC Suitability in Annuity Transactions Model Regulation

Discussions concerning development of suitability standards applicable to both life insurance and annuity products began in earnest in the late 1990s.  Initiatives were undertaken at the NAIC to explore the feasibility of developing suitability standards that would apply to both life insurance and annuity products.

The NAIC began this review by establishing a Suitability Working Group that developed a White Paper on Suitability.  In early 2000, the Suitability Working Group published its White Paper entitled:  *Suitability of Sales of Life Insurance and Annuities*.  The White Paper included a recommendation for the NAIC to consider developing a Model Law or Regulation to address suitable sales of non-registered life insurance and annuity products.  Further examination of this recommendation revealed that it would be more feasible to possibly develop a Model Law or Regulation applicable to non-registered annuity products rather than life insurance products.

In 2003, the NAIC identified potential issues associated with the sale of non-registered annuity products to seniors.  To address these issues, the NAIC charged its Suitability

Working Group to develop a Model Regulation designed to address the suitability of non-registered annuity product sales to seniors.

This initiative led to the development of the NAIC Senior Protection in Annuity Transactions Model Regulation.  This new Model Regulation imposed various requirements on insurers and producers regarding the suitability of sales of non-registered annuity products to seniors age 65 and above.

Thereafter, the NAIC revised the Senior Protection in Annuity Transactions Model Regulation by eliminating the age requirement and applying its provisions to all non-registered annuity sales; regardless of the age of the customer.

Several years later, the NAIC introduced an initiative to develop a Suitability in Annuity Transactions Model Regulation which was adopted by the NAIC in 2006.

One of the key provisions of the 2006 version of the NAIC Suitability in Annuity Transactions Model Regulation was the introduction of a "safe harbor" provision that allowed life insurers to satisfy suitability requirements pertaining to the sale of variable annuities to the extent they could demonstrate compliance with NASD Rules pertaining to suitability.  Another key provision also permitted insurers to contract with third parties to establish and maintain a system of supervision of the suitability of annuity sales.

During this time period, life insurers had to develop a myriad of compliance strategies in order to address the fact that some states had adopted the Senior Protection and Annuity Transactions Model Regulation whereas others chose to adopt the newer Suitability in Annuity Transactions Model Regulation.

## FINRA Suitability Rules:  FINRA Rules 2111 and 2090

In late 2006, the NASD and NYSE announced plans to merge and the merger was approved by the U.S. Securities and Exchange Commission (“SEC”) in mid-2007.  The merger of the NASD and NYSE led to the establishment of the Financial Industry Regulatory Authority (“FINRA”).

One of the primary charges that arose in light of the merger was the need to consolidate the rule books of the NYSE and NASD.  FINRA had been working on this consolidation initiative for several years and, in November 2010, the SEC approved a new FINRA suitability rule (FINRA Rule 2111) which was based upon former NASD Rule 2310 and a

new FINRA "Know Your Customer" Rule (FINRA Rule 2090) that was based upon the former NYSE Rule 405.

Since adoption of FINRA Rule 2111, FINRA has issued several Regulatory Notices (Regulatory Notices 11-02, 11-25 and 12-25) to clarify the scope and application of its new suitability rule.[1]

## 2010 Revisions to the NAIC Suitability in Annuity Transactions Model Regulation

As a growing number of states adopted the 2006 version of the NAIC Suitability in Annuity Transactions Model Regulation, the NAIC continued to explore additional modifications to the Model Regulation.

The NAIC convened a Working Group to examine possible revisions to the NAIC Suitability in Annuity Transactions Model Regulation.  In 2010, the NAIC adopted revisions to the 2006 version of the NAIC Suitability in Annuity Transactions Model Regulation to include, among its other provisions, specific requirements with respect to training of producers (continuing education and product-specific training) and “secondary review” of the suitability of non-registered annuity transactions.

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This Survey was designed primarily to gauge current industry practices regarding these state insurance regulatory developments.  Therefore, the Survey questions were designed to evaluate various compliance strategies life insurers employ currently with respect to demonstrating compliance with the requirements of the 2010 version of the NAIC Suitability in Annuity Transactions Model Regulation.

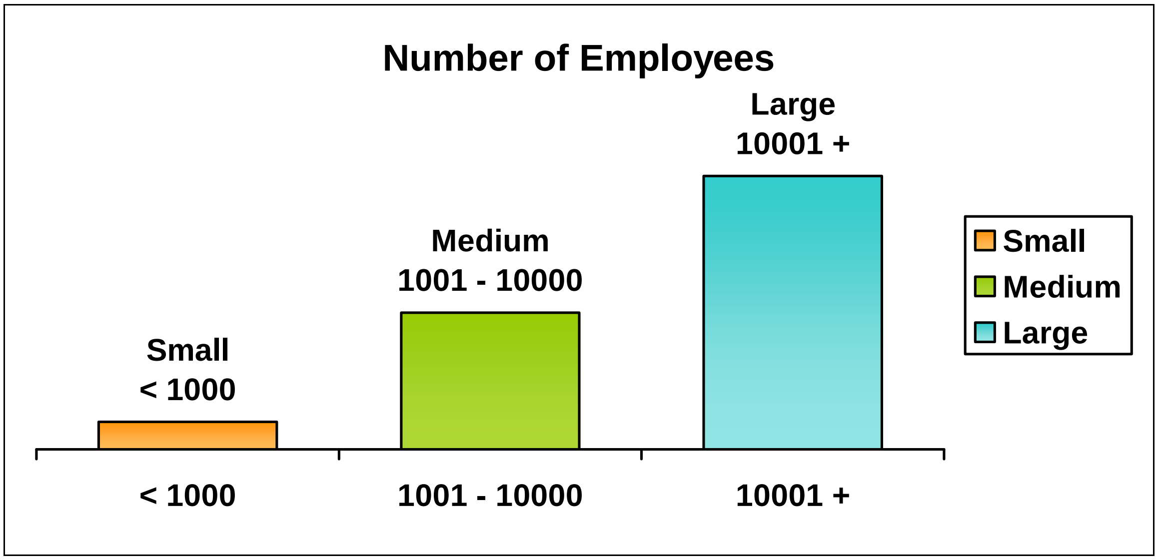
[1] A detailed discussion of applicable suitability laws and regulations is beyond the scope of this Survey Report.

## Methodology

To complete its review, CEFLI solicited input from both CEFLI member life insurance companies as well as non-CEFLI member life insurance companies. CEFLI received Survey responses from 56 life insurance companies representing a range of company sizes (large, medium and small) and distribution systems.

Survey respondents were asked to indicate their company's size based upon its number of employees. For purposes of the Survey:

- Companies with less than 1,000 employees were deemed to be Small companies;
- Companies with more than 1,000 but less than 10,000 employees were considered to be Medium-size companies; and
- Companies with more than 10,000 employees were considered to be Large companies.




When Survey respondents were asked to characterize their role within their respective organizations, the majority of overall Survey respondents (66%) described their role as having responsibility for compliance oversight of annuity sales by the issuing life insurance company. Other roles reported by Survey respondents included business

management (10%), suitability reviewer for transactions (9%), compliance oversight of an affiliated broker-dealer (5%), administrative management (5%) and other (5%).

The Survey respondents were asked to identify what forms of distribution may be used by their company for purposes of annuity sales. The Survey examined several different categories of distribution systems including: captive agents, third-party distribution firms (selling registered products), third-party distribution firms (selling non-registered products), independent agents, direct sales (including Internet sales), worksite sales and other.

The Survey results indicated that small companies use primarily independent agents for annuity product sales but also use third-party distribution firms (selling non-registered products) to a lesser degree. Medium-size companies reported using a broader range of distribution systems and use (in descending order) third-party distribution firms (selling registered products), captive agents, third-party distribution firms (selling non-registered products) and independent agents to distribute annuity products. Large companies reported four dominant means of annuity distribution which were equally divided between the use of third-party distribution firms (selling registered products), third-party distribution firms (selling non-registered products), captive agents and independent agents.

In sum, the respondents to the Survey constituted a representative cross-section of different company sizes, roles and responsibilities and distribution systems for purposes of analysis of annuity suitability practices.

## Summary

The overall Survey results indicate that the life insurance industry continues to examine a range of strategies to encourage and promote suitable annuity sales. These findings are supported by the broad representation of Survey respondents throughout the industry and the number of issues explored during the analysis.

The life insurance industry has a long history of demonstrating compliance with annuity suitability requirements. Applicable regulatory requirements continue to evolve with respect to distribution of registered products (e.g., variable annuities) as well as non-registered products (e.g., fixed and indexed annuities). These developments prompted the initiation of the Survey as companies continue to examine appropriate strategies to address annuity suitability issues.

The 2010 revisions to the NAIC Suitability in Annuity Transactions Model Regulation introduced new concepts with respect to annuity suitability. The 2010 version of the Model Regulation is being adopted by more and more states and, therefore, companies have developed various strategies to demonstrate compliance with its requirements.

The Survey indicated that approximately half of the responding companies are planning to apply the requirements of the Model Regulation in all jurisdictions regardless of whether a particular state has adopted the Model Regulation. Other companies are conducting a state-by-state analysis of annuity suitability requirements.

With respect to training requirements under the Model Regulation, companies are examining various strategies to address the continuing education and product-specific training requirements. Most companies are using third-party vendors to track completion of the state continuing education and product-specific training requirements. Moreover, the majority of Survey respondents indicated that their company requires their producers to undergo product-specific training every time there is a material product change.

In addition, the Survey results indicate that companies have taken a stringent review of the necessity to comply with the Model Regulation's training requirements by rejecting business submitted by producer that has failed to meet these requirements.

Company practices differ with respect to the manner in which they conduct a "secondary review" of annuity transactions.  In fact, many companies have established a separate functional area whose primary responsibility is to conduct the "secondary review."

Supervision and monitoring of the suitability of annuity transactions continues to present challenges in the marketplace.  Many life insurers contract with their third-party distribution partners to conduct supervision and monitoring of the suitability of annuity sales.  The Survey examined these practices and found that some companies will only permit contractual relationships for supervision and monitoring of annuity suitability for non-registered product sales to firms they can certify that they subject these transactions to FINRA's system of supervision.

Most large and medium-size companies distributing products through a broker dealer maintain contractual agreements to require the broker dealer to supervise and monitor registered annuity product sales.  Practices differ with respect to whether companies also authorizing the third-party distributor broker dealer to supervise and monitor non-registered annuity sales.  Some companies elect to conduct the review of non-registered annuity product sales through their internal annuity suitability review process.

The most common means used by life insurance companies to verify compliance by third-party distributors with contractual obligations to supervise and monitor the suitability of annuity sales is to obtain an annual certification of annuity suitability compliance. Many companies obtain these certifications through CEFLI's Annuity Suitability Clearinghouse.

The Survey also sought to examine annuity suitability review practices at various companies.  Most companies indicated that they use "red flags" (as determined by the company) to identify specific cases that may warrant "heightened review."  Companies also rely heavily upon complaint activity as a primary means to identify possible unsuitable sales.

In the event a specific transaction may require "heightened review," the decision as to whether to escalate such a transaction generally lies within the Compliance department. However, as the Survey results indicate, company practices vary.

The Survey asked questions to discern the areas of focus and types of information sought by state insurance examiners conducting examinations to determine compliance with annuity suitability requirements.  The Survey findings indicated that most states are focused on having insurers provide documentation to support the transactional suitability determination.

We also are encouraged to see that many companies have taken steps to raise awareness of potential cognitive impairment of senior customers.  Several companies reported developing training programs to raise awareness of these issues with their producers.

*CEFLI would like to thank all compliance and ethics professionals from CEFLI Member Companies as well as non-CEFLI Member Companies who responded to the 2012 CEFLI Annuity Suitability Benchmarking Survey for offering your insights and perspectives.  We hope that all Survey respondents find this information to be useful.  CEFLI also would like to thank its Member Companies and Affiliate Members for their financial support of the 2012 CEFLI Annuity Suitability Benchmarking Survey.*

# THE FORUM THAT CONNECTS.

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