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## Scrutiny of Annuity Sales Increasing: Are You Prepared?

by Christine M. Debevec and Caitlin E. Oberst

In the past decade, insurers have seen a tremendous growth in the sales of annuities, many to senior consumers. This growth, unfortunately, has been coupled with increased complaints of inappropriate, unsuitable and even fraudulent sales of annuities. As one example, recent media coverage and lawsuits accusing annuity brokers of fraudulently processing stranger-owned annuity transactions (STATs) involving terminally ill annuitants have piqued the interest of insurance regulators. In fact, the National Association of Insurance Commissioners (NAIC) held a public hearing in May 2010 about this suspect practice in order to determine whether current laws and regulations provide adequate consumer protection with regard to these kinds of transactions.

These types of concerns about the suitability of variable annuities have long been a focus of federal and state securities regulators, who have repeatedly reminded securities broker-dealers of their obligation to confirm that a consumer's purchase or exchange of a variable annuity is suitable and have instituted enforcement and disciplinary proceedings against those firms that fail to do so.

However, since fixed annuities are not considered securities, they are regulated only by state departments of insurance and traditionally were not subject to the same suitability requirements as variable annuities. In March 2010, the NAIC took action to recommend model regulations to bring all annuities in line with existing securities regulations governing variable annuity transactions.<sup>1</sup> This article addresses the key points of the new suitability, training and supervision standards that insurers and producers should expect to see implemented by states in the near future.

### New NAIC Model Regulation

The 2010 NAIC Suitability in Annuity Transactions Model Regulation (the Model Regulation) expands upon prior versions of the model regulation, which was initially promulgated in 2003 and amended in 2006. If past history is any indication, most states will likely adopt the 2010 Model Regulation to subject fixed annuity transactions to increased supervision and suitability requirements. Approximately 40 states have eventually adopted the 2006 Model Regulation in some form (Pennsylvania's legislature only recently adopted the 2006 version, to become effective later this year).<sup>2</sup> Although some states (Arkansas, Delaware, Florida, Indiana and Nebraska) have imposed these suitability requirements only on the sales of annuities to *seniors*, other states (including Pennsylvania) have applied them to *all* annuity transactions.

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## Scrutiny of Annuity Sales

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As discussed further below, the 2010 NAIC Model Regulation contains three new significant features:

1. More extensive suitability standards that are now consistent with the suitability requirements enacted by the Financial Industry Regulatory Authority (FINRA) on the sale of variable annuities;
2. A clarification that the insurer remains responsible for compliance with the suitability requirements, including the review of all recommendations *prior* to the issuance of an annuity contract; and
3. A requirement that producers undergo mandatory training to understand the products they sell.

### Suitability Obligations

The 2006 version of the NAIC Model Regulation required that, prior to recommending an annuity, a producer or an insurer make reasonable efforts to obtain information about the consumer's financial status, tax status, and investment objectives, as well as other information that could be used in making a recommendation to the consumer. The newly revised 2010 Model Regulation, however, imposes a substantially higher benchmark for determining the "suitability" of all types of annuities, closely approximating FINRA standards applicable to variable annuity sales.<sup>3</sup>

First, the 2010 Model Regulation requires that the producer have "reasonable grounds" to believe that the annuity recommendation is suitable for the consumer. This suitability determination is to be made from "suitability information" disclosed by the consumer about his investments and other insurance products and his financial situation and needs. Such "suitability information" consists of 12 different factors, including the consumer's intended use of the annuity, financial time horizon, existing assets, liquidity needs, liquid net worth, and risk tolerance.<sup>4</sup> These 12 suitability factors are clearly more expansive than the few listed in the 2006 version of the Model Regulation.

Second, the producer or seller of the annuity must also have a "reasonable basis" to believe that the annuity as a whole, its unique features, and the transaction itself are in the best interests of, and can be understood by, the

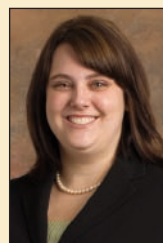
consumer. Specifically, the producer must reasonably believe that:

1. the consumer is reasonably informed of the annuity's features;
2. the consumer will benefit from certain features of the annuity, such as tax-deferred growth, annuitization, or a death or living benefit;
3. the particular transaction, the annuity as a whole, the underlying subaccounts, and any riders and similar product enhancements are suitable for the particular consumer; and
4. as applicable, the exchange or replacement is suitable, considering surrender charges, increased fees, benefits from product enhancements and improvements, and other exchanges or replacements within the preceding 36 months.

Both the 2006 and 2010 versions of the Model Regulation limit the producers' obligations to the consumer where the consumer refuses to provide complete or accurate suitability information or enters into an annuity transaction that expressly is not recommended. The 2010 Model Regulation further limits the obligations to a consumer where no recommendation is made at all or where a recommendation is based on materially inaccurate information provided by the consumer.<sup>5</sup>

### Systems of Supervision and Training

The 2006 version of the Model Regulation merely required insurers and producers to maintain written procedures and to conduct periodic reviews of their



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records in order to prevent violations. The 2010 Model Regulation provides additional guidance for establishing effective supervisory procedures.<sup>6</sup>

Under the newly-amended Model Regulation, producers must make a record of any annuity recommendation, and obtain a consumer signed statement if the consumer refuses to provide the required suitability information or decides to purchase an annuity not based on a recommendation. In addition, *prior* to the issuance of an annuity contract, the insurer (or a third party with whom the insurer has contracted) must review annuity recommendations to ensure that there is a reasonable basis to believe the transaction is suitable. This may be accomplished by a screening system that would identify selected transactions for additional scrutiny. The insurer also will be required to maintain reasonable procedures to detect recommendations that are *not* suitable, including confirming consumer suitability information, conducting customer surveys and interviews, sending confirmation letters and establishing internal monitoring programs. Finally, the Model Regulation mandates that insurers train their producers on the new suitability requirements and on the products themselves (via a minimum four-hour training course on annuities in general and product-specific training).<sup>7</sup> It should be noted that under the Model Regulation's safe harbor provision, sales of annuities already in compliance with FINRA rules will comply with the new NAIC suitability regulation as well.<sup>8</sup>

### Industry Response and Potential Ramifications of Increased Regulation

Not surprisingly, insurance carriers and producers typically have resisted the trend of increased regulation of fixed annuity transactions. In particular, small independent producers and mid-sized firms argue that a FINRA-based suitability model, requiring producers to obtain detailed investment and background information about the clients and to make suitability determinations, is outside the regular scope of business for producers who work only in fixed insurance products. Some insurance agents may have difficulty implementing and complying with new procedures that will require them to probe into their clients' financial wherewithal and financial affairs.

Another concern for the insurance industry lies in the NAIC's decision to pattern the 2010 Model Regulation on FINRA Rule 2330, which established sales practice standards for *distributors* (broker-dealers) of deferred variable annuities. Those provisions that are based on FINRA Rule 2330 may not translate to insurers as

*manufacturers* of the annuity product (and not broker-dealers). The sales process for insurance products differs significantly from that of the sales of securities. For instance, if a broker-dealer refuses to sell a stock to a customer because it is not suitable for him, the customer nevertheless can typically buy it himself in the open market. The same is not true for insurance products that are available only from an insurer or a producer. Thus, additional oversight of annuity sales could delay the process of approving, underwriting and issuing fixed annuity products, resulting in increased costs and interest-crediting rates for annuities.

On the other hand, many producers embrace as best practices new regulations subjecting insurance agencies to a suitability review and approval process similar to that of their counterparts in the securities industry. Further, compliance could be accomplished by relatively simple means – for example, by requesting more information from consumers on initial applications and adding software modules for suitability documentation, screening and monitoring.

In short, it is clear that suitability in the sale of annuities will be carefully monitored by insurance regulators in Pennsylvania and around the country as states consider adopting the new NAIC suitability standards. Increased training and supervision may also be in store for insurers and producers if state legislatures decide to fall in line with the most recent additions to the NAIC Model Regulation. ■

<sup>1</sup> See *Suitability in Annuity Transactions Model Regulation* (“*Model Reg.*”), available on Westlaw at NAIC 275-1; see also NAIC Executive Summary, available at [http://www.naic.org/documents/committees\\_a\\_suitability\\_reg\\_guidance.pdf](http://www.naic.org/documents/committees_a_suitability_reg_guidance.pdf). The Model Regulation is also available for purchase through the NAIC's website at [www.naic.org](http://www.naic.org).

<sup>2</sup> See 40 Pa. Stat. § 627-1, *et seq.* (effective Sept. 20, 2010).

<sup>3</sup> See FINRA Rule 2330 (Members' Responsibilities Regarding Deferred Variable Annuities), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=8824](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8824); see *Model Reg.* at Section 6A (Duties of Insurers and Insurance Producers).

<sup>4</sup> Section 51 of the 2010 Model Regulation defines “suitability information” to mean information that is reasonably appropriate to determine the suitability of a recommendation, including the following: (1) Age; (2) Annual income; (3) Financial situation and needs, including the financial resources used for the funding of the annuity; (4) Financial experience; (5) Financial objectives; (6) Intended use of the annuity; (7) Financial time horizon; (8) Existing assets, including investment and life insurance holdings; (9) Liquidity needs; (10) Liquid net worth; (11) Risk tolerance; and (12) Tax status. These are the same 12 factors found in FINRA Rule 2330(b)(2).

<sup>5</sup> See *Model Reg.* at Section 6D.

<sup>6</sup> See *Model Reg.* at Sections 6E and 6F.

<sup>7</sup> See *Model Reg.* at Section 6F(a) – (c), and Section 7.

<sup>8</sup> See *Model Reg.* at Section 6H.



## 2010 Executive Insurance Summit

Stradley Ronon and LECG-SMART hosted the 2nd Annual Executive Insurance Summit: Trends Affecting the Industry. The half-day summit featured industry experts who discussed current challenges facing senior executives in the insurance industry. Pictured from left: Vincent Burke, Senior Managing Director, LECG-SMART; William R. Sasso, Chairman, Stradley Ronon; Joel Ario, Insurance Commissioner, Pennsylvania Department of Insurance; Steven B. Davis, Co-Chair Insurance Practice Group, Stradley Ronon; and John J. Swanick, Senior Managing Director, LECG-SMART.

## Stradley Ronon At Work

In March, the Pennsylvania Commonwealth Court issued a 3-2 decision in favor of the insurance industry in *Allstate Life Insurance Company v. Commonwealth*. The Court decided that carriers are entitled to take a tax credit for fixed annuity assessments paid to the Pennsylvania Life and Health Insurance Guaranty Association. Stradley Ronon attorneys represented an insurance trade group as *amicus curiae* before the Court.

Stradley Ronon was instrumental in developing a new risk management and insurance major at Saint Joseph's University. With support from insurance executives comprising Saint Joseph's Risk Management and Insurance Board, the program awards \$75,000 in scholarships annually; is one of 21 schools globally with a Global Association of Risk Professionals collegiate chapter; and recently hosted for the second year, The Energy School, which attracts insurance executives nationwide for training on how to adapt to the challenges of protecting our nation's energy companies from shattering losses.

Stradley Ronon attorney Neal Troum presented at the Securities Regulation Committee Meeting of the Philadelphia Bar Association. Mr. Troum's



Neal R. Troum

presentation concerned *Morrison v. National Australia Bank*, the extraterritorial application of federal securities laws, and "Foreign Cubed" cases," looking at the *Morrison* case before the Supreme Court and the role of U.S. courts in foreign securities fraud claims.

Stradley Ronon Insurance Practice Group Partners Steven Davis and Samuel Arena were recently named "Pennsylvania Super Lawyers" for 2010. Featured in *Philadelphia Magazine's* May 2010 issue and *Pennsylvania Super Lawyers Magazine*, these attorneys are among the top five percent of lawyers in Pennsylvania, as chosen by their peers and a nomination committee review. In addition, Securities Practice Group attorneys Thomas W. Dymek, Leslie Miller Greenspan and Insurance Practice Group attorney Karl S. Myers were selected by their peers statewide as the top 2.5 percent of up-and-coming attorneys in Pennsylvania, and named "2010 Pennsylvania Rising Stars" in *Philadelphia Magazine* and *Pennsylvania Super Lawyer Magazine*.



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