# Marketplace & Regulation

# 3

In 1759, Pennsylvania chartered the "Corporation for the Relief of Poor and Distressed Presbyterian Ministers and Distressed Widows and Children of Ministers" to provide periodic payments to retired ministers and their survivors. From that humble beginning, the market for annuities in the United States has evolved into a dynamic marketplace collecting contributions totaling over $230 billion in 2007. Today's annuity companies have also evolved. Aside from having less-distressing sounding names than their colonial forbearer, the annuity industry has created a variety of products to meet the needs of a diverse clientele — ranging from private individuals to Fortune 500 companies. Annuities, which once represented a small percentage of the insurance industry's business, now represent a major source of its revenues.

Annuities, in one form or another, have been around for over two thousand years. In Roman times, speculators sold financial instruments called *annua*, or annual stipends. In return for a lump sum payment, these contracts promised to pay the buyers a fixed yearly payment for life, or sometimes for a specified period of term. The Roman Domitius Ulpianus was one of the first annuity dealers and is credited with creating the first life expectancy table.

During the Middle Ages, lifetime annuities purchased with a single premium became a popular method of funding the nearly constant war that characterized the period. There are records of a form of annuity called a tontine. This was an annuity pool in which participants purchased a share and, in turn, received a life annuity. As participants died off, each survivor received a larger payment, until finally, the last survivor received the remaining principal. Part annuity, part lottery, the tontine offered not only security but also a chance to win a handsome jackpot.

During the 18th century, many European governments sold annuities that provided the security of a lifetime income guaranteed by the state. In England, Parliament enacted hundreds of laws providing for the sale of annuities to fund wars, to provide a stipend to the royal family, and to reward those loyal to it. Fans of Charles Dickens and Jane Austen will know that in the 1700s and 1800s, annuities were all the rage in European high society. Annuities owed this popularity among the upper class to the fact that they could shelter annuitants from the "fall from grace" that occurred with investors in other markets.

The annuity market grew very slowly in the United States. Annuities were mainly purchased to provide income in situations where no other means of providing support were available. Few people saw the need for structured annuity contracts to guarantee themselves an income if they could rely on support from their extended families. Annuities were mostly purchased by lawyers or executors of estates who needed to provide income to a beneficiary as described in a last will and testament.

This all began to change at the turn of the 20th century, as multi-generational households became less common. The Great Depression was especially significant in the history of annuities. Until

then, annuities represented a miniscule share of the total insurance market (only 1.5% of life insurance premiums collected in the US between 1866 and 1920). During the Great Depression, investors sought out more reliable investments in order to safeguard themselves from financial ruin. With the economy less stable than it had ever been, many individuals looked to insurance companies as a haven of stability in what seemed a sea of anything but. Today, annuities represent roughly 30% of premium dollars collected by insurance companies.

## Private vs. Commercial Annuities

Annuities have existed for centuries, long before the advent of modern-day annuity companies. Jane Austen's character Mrs. Dashwood, whom we met in the introduction, was referring to a private annuity contract between her husband and his half-sisters. Private annuities continue to exist today — in fact any kind of installment sale can be viewed as creating an annuity (a stream of payments). Unlike standard installment sales, private annuities require the buyer to continue payments for the seller's lifetime.

The tax code acknowledges the sale of property or business interests in exchange for private annuities, and these tax provisions can afford substantial estate and income tax planning advantages. What sets a private annuity apart in the tax code is that the party agreeing to make the annuity payments in the future cannot be in the business of writing annuities. In many cases, private annuities are contracts between family members. A mother might sell her share of the family business to her children in return for a lifetime of income payments. It provides a way for the family to transfer ownership in the business to the next generation and lock in the price of that asset at today's value. This transfers future appreciation from the mother's eventual estate to the children and lowers the family's estate tax liability. If structured properly, the mother receives a lifetime income, which is treated as partial tax-free return of principal (using the exclusion ratio concept) — and it also delays recognition of any capital gain from the sale until the annuity payments are paid. The mother, of course, runs the risk that her children will not pay the promised payments for whatever reason (business failure, personal animosities, etc.). As Mrs. Dashwood would say, "Annuities are a serious business..."

Commercial annuities, on the other hand, are contracts issued by companies in the business of writing annuities — in most cases, annuity companies are also life insurance companies. Companies in the business of writing commercial annuity contracts do so to make a profit. They rely on the Law of Large Numbers and their expertise in calculating mortality (or survivorship) factors. The Law of Large Numbers states that given enough exposures, mathematical probabilities can become absolute certainties. Toss a coin once and it is impossible to predict whether it will land heads or tails. Toss it a hundred times, and chances are good that it will come up heads roughly 50 times (and tails 50 times). Toss the coin a million times, and it is very certain that the split will be exactly 50%-50%. Insurance companies use this law to accurately predict the mortality and survivor experience of large numbers of people — and be able to turn a risky proposition into a fairly safe and profitable one.

The rest of this course will concentrate on commercial annuity contracts.

## Ratings

A commercial annuity is only as secure as the insurance company issuing it. One simple way to analyze a company's strength is to review its rating. Six major credit agencies determine insurers' financial strength and viability to meet claims obligations. They are A.M. Best Co.; Duff & Phelps Inc.; Fitch, Inc.; Moody's Investors Services; Standard & Poor's Corp.; and Weiss Ratings, Inc. These companies consider factors such a company earnings, capital adequacy, operating leverage, liquidity, investment performance, reinsurance programs, and management ability, integrity and experience. (Note: A high financial rating is not the same as a high consumer satisfaction rating, or vice versa.)

An annuity company's rating measures the financial strength of the company — as such, they should be used when analyzing fixed (including indexed) annuity contracts that are backed by the company's general assets. Ratings do not apply to separate accounts (investment portfolios) held within a variable annuity. Clients should not rely on these ratings to determine the quality of investments within a variable annuity's separate accounts, but ratings can be helpful in gauging the company's ability to back up a variable annuity's guaranteed values, such as the minimum death benefit.

For details on each rating agency's methodology and rating systems, please refer to the agency's website.

| | |
|---|---|
| A.M. Best | ambest.com |
| Standard & Poor's | standardandpoors.com |
| Moody's | moodys.com |
| Fitch | fitchratings.com |
| Duff & Phelps | duffandphelps.com |
| Weiss Ratings | weissratings.com |

Most annuity companies will refer to their ratings in their marketing literature and post their rating on their website.

As you would expect, prices for contracts issued by more highly-rated companies will be higher than prices for lower-rated companies. Advisors should limit their recommendations to higher-rated carriers, even at this means recommending that a client pay a slightly higher price or accept a slightly lower return. A weak annuity company represents a potential for financial loss to its contractholders, as well as a number of headaches and hassles. Failure could mean both loss of investment and loss of future income. Therefore, it is important to check the financial security offered by a company prior to purchasing an annuity and then periodically monitor the company's condition going forward.

*Note:* as we learned in the subprime mortgage market, rating organizations may be susceptible to influence. Insurers pay the ratings agencies for their rating, so there is an inherent conflict in the relationship. Ratings agencies typically rely on data from the past, and will not devote a lot of their analysis to projections of future trends. Thankfully there are a number of agencies, and viewed collectively, their ratings can provide useful insight into the company's financial strength.

## Individual and Group Contracts

As is the case with life insurance, annuity contracts can be broken into two basic categories: individual and group. Individual annuity contracts relate to an individual lives; group annuity contracts, by contrast, are one contract covering number of individuals. Most of this course will focus on individual annuity contracts, but a brief discussion of group annuity contracts is in order.

Insurance companies started to market group insurance policies — life, medical expense and disability — to corporations shortly after World War I. In the early 1920's, Metropolitan Life extended the group concept of annuities to the corporate pension market. Up until that time, corporations that offered employees a pension benefit (usually only to executives) would finance retiree benefits on a pay-as-you-go system out of current earnings (not unlike the current Social Security system). In 1921, Metropolitan started to manage corporate pension programs, collecting contributions while the workers were employed and paying out benefits upon their retirement. Eventually, the company introduced its own retirement plan program and began actively marketing group annuities. These early group annuity contracts called for employer and employee contributions during the working years, with a provision for the employee, at age 65, to take a lump sum or lifetime annuity payments. Unfortunately, the Great Depression hit before this market could fully develop. Promises of a minimal retirement benefit under the new Social Security System (enacted in 1935) also slowed development of the private-sector group annuity market. After World War II, the market for group annuities grew rapidly, pushed in part by collective bargaining agreements negotiated with organized labor. In 1941, only about a quarter of a million workers were covered by group contracts; twenty years later, that had grown to almost four million, and to 38 million by 1988 — its high water mark.

Pension plans funded with a group annuity contract were called "annuity purchase plans", for obvious reasons. In 1974, Congress enacted ERISA (Employee Retirement Income Security Act) as a response to the bankruptcy of Studebaker in 1964, and the resulting problems it caused for its employees and retirees. This federal law codified pension regulations — and created the two major classes of retirement plans we know today: defined benefit plans and defined contribution plans. The rules on defined benefit plans (the old annuity purchase plans) were tightened. At the same time, businesses that had traditionally offered annuity purchase plans (e.g., manufacturing and other heavy industries that used organized labor) began to shrink, while increasing numbers of workers became employed in the service sector and non-unionized industries. As a result of these changes, defined benefit plans were steadily replaced with defined contribution plans — and this reduced the market for group annuities. Defined contribution plans (centralized, "money purchase" plans or individualized 401k plans) focus more on accumulation of retirement savings, although they do have distribution features as well. Future growth in the group annuity marketplace today will focus on serving the distribution needs of defined contribution plans.

Generally speaking, group annuities (at least to large corporations) are placed through large insurance brokerage firms. Perhaps as the marketplace changes, and the Boomer generation reaches retirement age, there will be more opportunities for individual agents to capture some of the market for group annuities.

## Distribution channels

At one time, life insurance products (including annuities) were sold primarily through the insurer's "captive" sales force. Today, that is no longer the case. Over the past couple decades, changes in the marketing and distribution of individual life and annuity products have had a strong impact on industry growth and profitability. The changes in distribution have also spurred design of new product offerings. New distribution channels include banks, broker-dealers, wirehouses and the Internet, as well as fee–for–service financial planning. This expansion is partly the result of non-insurance companies diversifying their product mix; others resulted from mergers and consolidations with the financial services sector. These expanded channels increase the opportunity for insurers to access new customers, but they have also resulted in increased costs due to more intense regulatory scrutiny and new compliance requirements.

It's interesting to note, that while the industry has been very successful in broadening annuity distribution channels, it has had only limited success in doing the same for life insurance products. There are several factors contributing to this phenomenon. Market research by the Life Insurance Marketing Research Association (LIMRA) indicates that consumers tend to segment their financial activities into two broad groups — insurance and financial planning. Because consumers typically view annuities as investment products, they are often more willing to consider traditional investment product distribution channels, such as banks, stockbrokers, financial planners and other financial advisers, as acceptable sources for purchasing annuities. But when it comes to life insurance, consumers continue to gravitate toward traditional insurance professionals to buy life insurance. Today, stockbrokers and banks write approximately 40% of total individual annuity new business, while less than 10% of new individual life premium is written through these channels. (The trend for equity indexed annuities is different. More than 90% of indexed annuities are sold through personal producing general agents (PPGAs), unaffiliated insurance agents and insurance brokers. Banks, broker-dealers, and captive agents accounted for 4 %, 3%, and 1% of EIA sales, respectively.)

The shift to third party distribution was seen as a way to meet customers' calls for more independent sales representatives, as well as a way for companies to shift away the fixed costs of a captive sales force. There have been some unintended consequences, however. Insurance products, including annuities, have come to be viewed as interchangeable "commodities", and this has led to greater price competition. Companies also found themselves competing for limited "shelf space" as independent agents were given a wider variety of branded products to offer their clients. Both of these trends have placed greater pressure on company profitability. In addition, unaffiliated agents, with access to the products of several different carriers, can quickly discern and exploit any pricing or design mistakes to the detriment of insurers. The fact that these producers no longer have a strong affiliation with a single carrier means that they are more likely to shop around and recommend replacement of existing contracts when new products come to market. This can upset the "persistency" assumptions insurers make when pricing their products (persistency is the average length of time a contract stays in force). Insurers amortize their "contract acquisition costs" over a long period — any increase in policy surrenders has a negative impact on company profits.

In addition to the increased number of distribution channels, insurers have had to grapple with the logistics of bringing their product to this wider market. Firms no longer can simply develop a product and rely on its sales and training departments to roll out that product to captive agents. Insurance and annuity companies rely on various methods to reach its more-diverse sales force: in-house marketing personnel, wholesalers, brokers, and independent third-party marketing organizations. The distribution chain has become longer, and subject to forces outside the control of the underwriting carriers. This, in turn, has put old regulatory assumptions under pressure: Who is responsible supervising the agents? Who is responsible for determining whether a recommended product is suitable for a particular client?

Increased price competition and a wider range of alternative products would seem to benefit the annuity-buying public. But the downside is that the new sales force may not be as knowledgeable about the products they are selling, or they may be more concerned with the short-term gain afforded by generous commissions and less worried about long-term client satisfaction.

## Secondary market

Liquidating marketable securities such as stocks, bonds, or mutual funds is relatively easy and incurs few transaction costs. That has not been the case with annuity contracts. Deferred annuities allow for partial withdrawals or surrender, but in the early years of the contract there may be steep surrender fees to cash out. And once the contract is annuitized, those limited options are usually not available (a few contracts do offer “commutation” provisions to allow for surrender after annuitization). In some cases, beneficiaries inherit annuities that met the initial contractholder's needs, but do not fit the beneficiary's financial plan. Other contractholders may face an urgent need for cash due to financial emergencies, while others may simply find that their financial plan has changed for a number of reasons: investment strategies, estate planning or wealth transfer needs. Some annuity holders may simply have buyer's remorse and wish to undo a mistaken purchase.

A nascent secondary market for annuities is emerging, giving investors the opportunity to sell what was once unsalable and possibly cash in their policies for more than they could receive from the annuity company upon surrender. Ads on television tout sales of annuities proclaiming "It's your money, use it now" or by asking "Do you need money now?" The answer seems to be "yes". According to a survey of existing annuity contractholders by the American Council of Life Insurers (ACLI), 27% of respondents are concerned that they may be unable to sell their annuity if they want the money for something else.

A number of companies that previously filled a niche in turning a structured settlement (usually a judgment in a court case paid over time) into a lump-sum payout have expanded their services to include standard annuity contracts. This would seem to be a straightforward process: calculate the present value of a future income stream, deduct a little for profit, and cut a check. But according to the National Association of Insurance and Financial Advisors "it's a complicated, unregulated new field, and there are so many variables which make the calculations extremely complex and not transparent to the consumer." This market is unregulated. Currently, company representatives need not be licensed, and the purchasing companies do not fall under state insurance regulations or other government oversight.

The best advice for clients is *caveat emptor* (or more correctly, *caveat vendor* — "let the seller beware".) For those who may be interested in converting an annuity into a lump sum, the first step should be to contact the issuing annuity company. The administrative policies at the company may be more flexible regarding surrender than is apparent from the policy language. If a client is intent on pursuing the sale of his or her annuity, obtaining independent advice from an insurance specialist or actuary should be the first course of action — and then obtain a number of bids.

In an annuity sale, the price will be based on the total dollar amount to be distributed, the time period over which the payout will be made, and the current level of interest rates. Other considerations include the insurance company's financial strength rating and particular terms and conditions such as whether the policy has a death benefit. Each potential buyer will have its own methods of calculating a price, so there may be a wide disparity in possible payoff values — so shop around.

Even with this new market, not every policy can be turned into cash. Those tucked away in tax-qualified retirement accounts are ineligible because the Internal Revenue Service won't allow ownership to be transferred. Deferred annuities that are still in the accumulation phase can be sold in this marketplace. Annuities in their payout period can also be sold — but only those with a guaranteed payout period (such as period certain contracts) or other minimum guaranteed values. Straight life immediate annuities cannot be sold, as the future payments from these annuities are based on an unpredictable life expectancy. (The purchasers in this market do not deal with enough contracts to rely on the Law of Large Numbers).

Annuity companies and regulators tend to take a dim view of secondary market transactions for annuities. (Part of this, no doubt, stems from shady transactions in the viatical/life settlement market, which is provides a similar secondary market for life insurance policies.) But the availability of a method to cash out annuity payments for a lump sum might overcome many contractholders' hesitancy to purchase or annuitize a contract in the first place. So, in the long run, this secondary market may actually come to serve the industry's purposes. With over a trillion dollars currently locked away in annuity contracts, a secondary market could add needed liquidity and flexibility to the contract — allowing clients to find more suitable investments and allow agents to provide "value-added" services to their clients.

## Framework of Regulation

Given the central role the insurance industry plays in millions of American lives and businesses, it is no wonder that it is subject to a number of regulators – the federal government, state governments, and industry watchdogs. The primary purpose of this regulation is to promote the public welfare by maintaining the solvency of insurance companies. After all, policyholders depend on a company's financial stability to pay benefits well into the future. One insolvent company can jeopardize thousands of insureds. In addition to ensuring the financial strength of individual insurers, regulators also provide consumer protection, enforce fair trade practices and take care that insurance contracts are offered to the public at fair prices. It is very important that insurance agents be aware of and comply with all insurance laws and regulations.

### History of Regulation

Before exploring the current regulatory framework, a little background is necessary. The history of insurance regulation in the United States reveals a tug-of-war between the authority of the states and the federal government. Though a balance between these two bodies has been reached and maintained for many years, arguments favoring control by one governing authority over another are still being waged. For example, in 2008, the SEC proposed expansion of its jurisdiction to include equity index annuities.

In 1868, the U.S. Supreme Court, in the case of **Paul v. Virginia**, was faced with one state's attempt to regulate an insurance company domiciled in another state. The Supreme Court sided against the insurance company, ruling that the sale and issuance of insurance is not interstate commerce, thus upholding the right of each state to regulate insurance within its borders.

In 1905, the New York state legislature appointed a commission to investigate life insurers in that state. The **Armstrong Commission**, named for the New York state insurance commissioner, responded to public outcry over abuses by insurers. The result was the New York Insurance Code, which set a precedent and pattern for insurance regulation by other states throughout the country.

In 1944, the Supreme Court revisited the issue of continued state regulation of insurance in the case, **United States v. Southeastern Underwriters Association** (SEUA). In the SEUA case, the court overturned the decision of Paul v. Virginia – ruling, instead, that insurance is a form of interstate commerce to be regulated by the federal government. This case subjected insurance companies to a series of federal laws — many of which were in conflict with existing state laws. This decision did not affect the power of states to regulate insurance, but it did nullify state laws that were in conflict with federal legislation. The SEUA case resulted in a radical shift in the balance of regulatory control to the federal government.

The states responded angrily to the decision in the SEUA case, prompting Congress to enact the **McCarran-Ferguson Act** in 1945. This law made it clear that continued regulation of insurance by the states was in the public's best interest. However, it also made possible the application of federal antitrust laws *" ... to the extent that [the insurance business] is not regulated by state law."* As result, each state enacted an Unfair Trade Practices Act to conform to the federal law. Today, the insurance industry is considered to be state regulated.

In the mid-1950s, new insurance products such as **variable annuities** appeared in the marketplace. The question arose: "Are these insurance products to be regulated by the states or securities to be regulated federally by the Securities and Exchange Commission?" The Supreme Court answered "Yes" — federal securities laws applied to the underlying product, while the insurers that issued variable annuities were subject to state insurance regulators. As a result "variable" insurance products must conform to both SEC and state regulation.

During the Great Depression, the Glass-Steagall Act of 1933, barred common ownership of banks, insurance companies and securities firms -- and erected a regulatory wall between banks and non-financial companies. Glass-Steagall came under repeated attack in the 1980s as financial institutions merged. In 1999, Congress passed the **Financial Services Modernization Act**, which repealed Glass-Steagall. Under this new legislation, commercial banks, investment banks, retail brokerages and insurance companies can now enter each other's lines of business.

The ongoing story of insurance regulation reflects the roles the courts and the federal government have played in regulating the insurance industry. As a rule, insurance companies have tended to side with the regulators they deemed weakest. In the early years of this country, the federal government was seen as the less stringent regulator. Now states are seen in that light – and by and large, the insurance industry has been content to keep primary regulation in the states' hands.

Before exploring state regulation, let's take a brief look at federal regulation of insurance.

## Federal Regulation of the Insurance Industry

Although the primary regulation of insurance is left to the states (under the McCarran-Ferguson Act of 1945), the federal government influences the annuity industry in three ways:

**Internal Revenue Code:** Insurance companies are taxed differently than most other corporations. Policyowners pay premiums, which insurance companies invest. Generally speaking, interest earned by insurance companies is not taxed. Uncle Sam is willing to defer taxation on that income until the policyowner withdraws it from the policy. In the case of life insurance (but not annuities) benefits paid from an insurance policy are free of income taxation.

**Retirement Plans:** The Employee Retirement Income and Security Act of 1974 (ERISA) regulates pension plans, other retirement accounts and employee benefit plans. This law overrides any state laws governing retirement plans and investments within those plans. Plans that meet ERISA requirements are said to be qualified, that is, they qualify for special tax treatment that allows their values to grow faster. ERISA also governs "employee benefit" plans such as employer-provided health care coverage.

**Variable Contracts:** as mentioned above, the Supreme Court ruled that variable annuities and variable life policies are considered securities under federal law. Investments within a variable annuity contract or insurance policy itself falls under the jurisdiction of the SEC, while the companies issuing these contracts or policies are subject to regulation by the states. Likewise, agents selling variable products must be dually licensed: a state license as an insurance agent and federal license as a securities representative.

*Federal Securities Laws*

**Securities Act of 1933:** requires companies issuing securities (stocks, bonds, etc.) to register those securities with the SEC. It also requires all sales of "new issues" to be accompanied by a prospectus. Most variable annuities must be registered under this Act (some group variable annuities sold to qualified retirement plans need not register). Some equity indexed annuities are registered, but most remain unregistered.

**Securities Exchange Act of 1934:** regulates trading of securities once they have been issued. It also requires registration of broker/dealers and their sales representatives. The Financial Industry Regulatory Authority (FINRA) currently administers registration of broker-dealers and sales personnel. [This organization resulted from the merger of regulatory powers of the New York Stock Exchange and National Association of Security Dealers (NASD)]. FINRA's jurisdiction covers securities registered under the '33 Act. As such, FINRA rules apply to variable annuities (and a few equity indexed annuities), but do not extend to fixed annuities (including most indexed annuities) or other insurance products.

**Investment Company Act of 1940:** imposes requirements on professionally managed investment portfolios such as mutual funds. These portfolios must be registered with the SEC. The Supreme Court ruled that "separate accounts" of variable life insurance and variable annuities are also subject to this Act. This law treats sales of these types of investment companies as "new issues". As a result, they are subject to the prospectus requirement of the Securities Act of 1933.

We will explore FINRA regulations governing suitability of annuities in Chapter 6. At this point, however, it is important to note that FINRA suitability regulations apply only to the sale of "registered" products: namely individual variable annuity contracts (and a few equity indexed annuities).

In addition, many other federal laws have an impact on the operations of insurance companies and their agents -- including disclosures under the Fair Credit Reporting Act and privacy guidelines imposed under the Financial Services Modernization Act.

## Florida's Department of Financial Services and Office of Insurance Regulation

The **Department of Financial Services**, headed by Florida's Chief Financial Officer, and the Commissioner of the **Office of Insurance Regulation** oversee the insurance industry in accordance with the provisions of the Florida Insurance Code. They each have administrative (enforcement), quasilegislative (rule-making) and quasijudicial (hearing and penalty) powers in order to carry out their responsibilities.

The **Florida Insurance Code** is a broad set of regulatory principles. It sets general policy, but leaves the details of regulation to the Department and Office. For example, the Insurance Code states that advertising of insurance products should be balanced and not misleading. How that general principle is interpreted in day-to-day operations is spelled out in rules promulgated by the

Department of Financial Services or Office of Insurance Regulation. Rules will answer detailed questions such as: When are testimonials permitted? How are statistics to be used?, Must agents obtain insurer permission prior to placing an advertisement?, etc.

The Florida Legislature adopted a Policyholder Bill of Rights to protect the insurance buying public. The Bill of Rights sets forth a series of aspirational goals to guide the Department and Office in their day-to-day operations. The Policyholder Bill of Rights can be found in the Florida Statutes, Chapter 626.9641.

**Florida Policyholders' Bill of Rights**

(1) The principles expressed in the following statements shall serve as standards to be followed by the department, commission, and office in exercising their powers and duties, in exercising administrative discretion, in dispensing administrative interpretations of the law, and in adopting rules:

(a) Policyholders shall have the right to competitive pricing practices and marketing methods that enable them to determine the best value among comparable policies.

(b) Policyholders shall have the right to obtain comprehensive coverage.

(c) Policyholders shall have the right to insurance advertising and other selling approaches that provide accurate and balanced information on the benefits and limitations of a policy.

(d) Policyholders shall have a right to an insurance company that is financially stable.

(e) Policyholders shall have the right to be serviced by a competent, honest insurance agent or broker.

(f) Policyholders shall have the right to a readable policy.

(g) Policyholders shall have the right to an insurance company that provides an economic delivery of coverage and that tries to prevent losses.

(h) Policyholders shall have the right to a balanced and positive regulation by the department, commission, and office.

(2) This section shall not be construed as creating a civil cause of action by any individual policyholder against any individual insurer.

The Department of Financial Services focuses its regulations and authority on consumer and agent issues, such as agent licensing and anti-fraud efforts; while the Office of Insurance Regulation concentrates on regulation of insurance companies and contract terms. The Department and the Office are empowered to investigate complaints, audit industry participants, and, if need be, rehabilitate insolvent insurers. Let's take a quick look at a few regulations Florida imposes on insurance companies and agents.

## Insurers

### Certificates of Authority

An admitted insurance company is one that the Office of Insurance Regulation has licensed to transact business in Florida under the provisions of the state laws. Another way of stating this is that an "admitted" company has a certificate of authority to operate in Florida. For this reason, admitted companies are also called "authorized" companies.

Insurance companies that have not been authorized by the Office are said to be "nonadmitted". Agents and the public should be aware that a nonadmitted insurance company does not come under the jurisdiction of the Florida Office of Insurance Regulation with regard to examination of its financial soundness, nor the examination and approval of types of coverages offered, nor of its advertising through the mails. Florida's Life and Health Guaranty Fund (described below) only covers the liabilities of authorized insurers, so anyone purchasing policies from unauthorized or unlicensed companies would be at risk if those insurers could not meet their claims. Some states, including Florida, will hold the agent personally liable for any insurance contract he or she places with an unauthorized insurer.

The Department of Financial Services imposes severe penalties on **agents who aid and abet** these illegal operations:

- Conviction of a third-degree felony,
- Liability for all unpaid claims, and
- Suspension or revocation of all insurance licenses.

The Office of Insurance Regulation imposes similar penalties for **acting as an insurer without proper licensure**:

- Conviction on charges of up to a first-degree felony,
- Liability for all unpaid claims, and
- Suspension or revocation of all insurance licenses.

The State of Florida has taken a very strong position on the issue of authorized entities. An unauthorized entity is an insurance company that is not licensed with the Florida Department of Financial Services. Agents and brokers have responsibility for conducting reasonable research to ensure that they are not writing policies or placing business with unauthorized entities. Lack of careful screening can result in significant financial loss to Florida residents due to unpaid claims and/or theft of premiums. Agents may be held liable when representing these unauthorized entities. It is the agent's and broker's responsibility to give fair and accurate information regarding the companies they represent.

Any question about the authorized status of a company can be checked by calling the **Florida Department of Financial Services at 1-877-693-5236 (inside Florida) or 850-413-3089 (outside Florida).**

## Solvency

The public relies on insurance policies to address the financial uncertainties of life. Insurance policies are only of value to the public if there is a high probability that the company will be able to fulfill its promises far into the future. One of the primary reasons for state regulation of insurers is to ensure the financial integrity of insurance companies operating in the state. The focus of Florida's Insurance Code and the Office of Insurance Regulation is to monitor the continued solvency of insurance companies. The Office requires companies to file annual reports, and the Office will audit a domestic insurance company's complete financial and operating situation at least every three years.

Occasionally, an insurance company will fail, i.e., be declared insolvent. When this happens, the Office of Insurance Regulation will appoint a receiver to handle the liquidation or reorganization of the insurer in a process similar to bankruptcy. Upon liquidation, the **Florida Life and Health Guaranty Association** – an organization comprised of all authorized life and health insurers in Florida — will take over the duties of the failed insurer: collecting premiums, servicing the policy and paying claims. The association assesses its member firms to fund those payouts. Through this association, the industry collectively "bails out" the occasional failed firm. The Association will pay claims against the failed company's traditional life insurance products (but not variable policies or contracts). The Association will pay up to $300,000 in death benefits for life insurance ($100,000 in cash value) or $300,000 for fixed annuity payments. These limits represent the total amount payable per insured life, not per policy.

While these organizations exist to provide an extra level of protection for policyholders, Florida law prohibits agents from referring to this protection as part of their sales presentations.

## Investments

Insurance companies collect premiums from contract owners and invest those funds. These investments, which make up part of the "general assets" of the insurance company, back the company's promises to its fixed annuity contractholders. Income from investments offsets the total cost of future claims. The Office of Insurance Regulation imposes investment guidelines on insurance companies to safeguard those assets and income – and mandates methods for valuing those assets for financial statement purposes.

The general account of life insurance companies may be invested in obligations of the federal, state or local governments, corporate bonds, real estate mortgages, real estate, corporate stocks and policy loans. These long-term investments balance the long-term commitments insurance companies make to their policyholders. These categories of investments also provide the degree of safety of principal, yield and liquidity desired by insurers. The Office imposes minimum ratings for corporate bonds held by insurers, and severely limits so-called "junk bonds" in the portfolio. Companies issuing equity indexed annuities will also invest in equity indexed options to hedge their liability under these contracts. These options are held in the company's general assets.

Variable annuities are backed by investments in "separate accounts". The investment guidelines mentioned above apply to the general assets of the company – and not those held in the separate

account. The only requirement for assets held in these separate accounts is that it have a "readily determined" market value –- that is, the investment be publicly traded (such as stocks on a stock exchange).

### Legal Reserve System

Florida's Insurance Code requires insurers to charge themselves a minimum liability on their financial statements — known as the legal reserve — for all policies and contracts currently in force. This liability amount represents future claims by policyowners. The Code has a standard valuation provision that dictates the assumptions and procedures insurance companies must use in calculating the size of their legal reserve.

The legal reserves appear as a liability on the company's balance sheet. The legal reserve is a measure of the insurance company's future liability under the contract. To remain solvent, insurers must maintain assets (investments) equal to – and hopefully greater than — the legal reserve.

## Agent Responsibilities

Florida law requires any individual who solicits insurance products, including annuities (fixed and/or variable) to hold a valid license issued by the Department of Financial Services. Once properly licensed, the individual also must be appointed by an insurance or annuity company to transact insurance on behalf of that company. A licensed agent is prohibited from transacting any kind of insurance (e.g., life, health, annuities, etc.) for which he or she is not properly appointed. An individual may not be appointed until that individual has been licensed for the same kind of insurance. In short, an agent must simultaneously hold a license from the state and an appointment from an insurance company to solicit or transact insurance. One is not effective without the other.

### Brokers vs. Agents

Brokers, unlike agents, legally represent the annuity purchaser (or prospective purchasers). A broker solicits and accepts applications for insurance and then places the coverage with an insurer. The business is not in force and the insurance company is not bound until it accepts the application. Technically speaking, a broker does not represent anyone until prospect or client requests coverage — then the broker represents the buyer.

This distinction between agent and broker becomes blurred in the annuity market when independent (unaffiliated) agents are appointed by various companies to sell their products. In many cases, a client will wish to purchase an annuity and the agent will show proposals from several different companies. Is the sales person an agent representing the company's products, or broker representing the client's needs? In practice, the regulatory distinction between brokers and agents is not significant, as Florida does not issue separate licenses for brokers. Instead, licensed agents may act as brokers for their clients. There is, however, an important legal distinction: brokers owe their ultimate fiduciary responsibility to their clients; agents owe a fiduciary responsibility to the company that appoints them. Since a company can only pay commissions to appointed agents, a broker legally owes a fiduciary responsibility to both his clients and the annuity company. Ethical

agents will strive to behave as fiduciaries for their clients, too. These conflicting interests can sometimes place an agent or broker in a difficult position.

### *Fiduciary Responsibility*

Many persons, not just insurance agents and brokers, act as fiduciaries. By definition, a *fiduciary* is a person in a position of financial trust. Attorneys, accountants, trust officers, pension plan trustees, stockbrokers and insurance agents are all considered fiduciaries. As mentioned above, agents and brokers may owe a fiduciary duty to both to the companies they represent and to the insurance buying public. Agents who make recommendations to clients have an obligation to be knowledgeable about the features and provisions of various insurance policies, as well as the prudent the use of these insurance contracts. Agents also must take the time to become acquainted with the client's financial needs, situation and objectives. Agents collect premiums on behalf of the insurers they represent. The agent has a fiduciary duty to make certain that these premiums are submitted to the insurer promptly. Agents must take care that these funds are not converted to one's own personal use or that company funds are commingled with the agent's personal funds. .

Insurance agents and brokers (and other fiduciaries) voluntarily accept this fiduciary responsibility and implicitly agree to carry out that duty in good faith. That has been interpreted by the courts to mean that fiduciaries must act reasonably to avoid negligence and to not favor anyone else's interest (including their own) over that of their clients or the companies that appointed them. While each profession may have its own definition of fiduciary responsibility, all agree on some basic tenets. Fiduciaries owe their principals:

**Utmost Care**. One standard applied to fiduciaries is the "prudent man rule", which states that the fiduciary should behave as a "prudent person" would under the same circumstances. This can be a very vague standard, but it is one that courts have relied on over the years. Professionals are usually held to a higher standard of conduct — to exercise "utmost care". This higher standard is warranted because professionals are assumed to be more knowledgeable and experienced than an ordinary prudent person. One can argue that clients seek out and are willing to pay for professional advice precisely because of the added knowledge and experience the professional brings to the decision-making process — and therefore should be held to that higher standard.

**Integrity** — this applies to the fiduciary's soundness of moral principle and character: the agent must act with fidelity to the principal's interest and with complete honesty.

**Honesty and Duty of Full Disclosure** of all material facts, either known, within the knowledge of or reasonably discoverable by the agent which could influence in any way the principal's decisions, actions or willingness to enter into a transaction.

**Loyalty** — An obligation to refrain from acquiring any interest adverse to that of a principal without full and complete disclosure of all material facts and obtaining the principal's informed consent. This precludes the agent from personally benefiting from secret profits, competing with the principal or obtaining an advantage from the agency for personal benefit of any kind.

**Duty of Good Faith —** includes total truthfulness, absolute integrity and total fidelity to the princi-

pal's interest. The duty of good faith prohibits taking advantage of the principal through the slightest misrepresentation, concealment, threat or adverse pressure of any kind.

In the case of conflicting interests, the agent must disclose the "**dual agency**" (acting for two parties at the same time) or risk being accused of fraud from either or both principals. Most brokers are compensated by commissions. This in itself creates a difficulty since there is an inherent conflict of interest. It is common knowledge to most insurance purchasers that agents and brokers earn a sales commission, which may mitigate the conflict somewhat. (That obviously does not excuse a broker for churning or twisting a client's coverage to earn additional commissions.)

The Florida courts addressed this commonly held knowledge in the case of *Beardmore v. Abbott*. Mr. Beardmore purchased an annuity through his broker, Mr. Abbott. Later, Mr. Beardmore let the contract lapse by not paying a required premium. Mr. Beardmore sued, claiming that his broker had not disclosed the amount of commission paid on the sale, and therefore Mr. Abbott breached his fiduciary responsibility. The courts ruled that Mr. Abbott did indeed have a fiduciary responsibility to Mr. Beardmore, but the broker's failure to disclose the full amount of his commission did not breach that duty (the court also found that the annuity purchase was suitable for Mr. Beardmore's needs). In this case, Mr. Beardmore did not inquire as to the size of the commission at the time of the purchase, and Mr. Abbott did not volunteer the information. If Mr. Beardmore had asked that question, presumably the courts would have ruled that Mr. Abbott must honestly disclose that information as a matter of fiduciary trust. It should be noted that Mr. Beardmore was very familiar with the insurance market, and knew that Mr. Abbott would receive a commission — it was disclosure of the exact amount that was the crux in this case. Agents should, at least, make clients aware that they may receive a commission as part of an insurance/annuity transaction. [It might also behoove agents to note that Florida law requires companies to use licensed agents to deliver policies in Florida and pay the "customary" commission to those agents (i.e., that there is no cost savings to the customer by purchasing the product through another agent or purchasing directly from the company).]

The fiduciary duty of insurance brokers was also addressed in another case: *Moss v Appel*. The Appels were a self-employed couple who hired Moss, a pension benefits consultant, to help them set up a defined benefit plan. Mr. Moss sold them an annuity as part of that plan and was hired to handle administrative paperwork for the pension plan. Mr. Moss received notice from the annuity company that it was in seeking additional capital to remain in business, but he did not alert the clients to that notice. The annuity company later became insolvent. The courts ruled that Mr. Moss, the broker, owed a fiduciary responsibility to his clients based on the sale of the annuity and the ongoing consulting/administrative contract. As the court noted: "It is undisputed that Moss was acting as an insurance broker, not an insurance agent employed by a particular company, when he sold the plaintiffs the annuity." Presumably that distinction means that Mr. Moss should have placed the client's interests above any duty he may have felt to keep the contract in force with the troubled annuity company (even if it was the company that compensated him for the sale). In this case, there was a contract with the clients to administer the plan. The court did not indicate how that continuing relationship might have affected its ruling — or for how long after the annuity sale Mr. Moss (in the absence of a continuing relationship) owed that duty to the Appels. These cases illustrate some of the problems that can arise for insurance brokers. As noted earlier, annuities are more likely to be "shopped around", which increases the likelihood that the sales person will be viewed as a broker, and not as an agent.

## Agent Licensing

The ***Florida Insurance Code*** requires anyone "transacting insurance" within Florida to have a Florida-issued license: a resident license for agents who reside in Florida or non-resident license for those living in other states and transacting business in Florida. The licensing law makes no distinction between agents and brokers. One of the major roles of an insurance agent is to solicit insurance. ***Florida*** law defines "**solicitation of insurance**" as:

> "any attempt to persuade any person to purchase an insurance product by: describing the benefits or terms of insurance coverage, including premiums or rates of return; distributing an invitation to contract to prospective purchasers; making general or specific recommendations as to insurance products; completing orders or applications for insurance products; or comparing insurance products, advising as to insurance matters, or interpreting policies or coverages.

Please note: under Florida law "insurance products" include annuities of all types — fixed, indexed and variable.

Unlicensed clerical personnel in insurance agencies may service a contractholder's account, answer clerical questions, assist contractholders with paperwork, etc. – provided they do so under the supervision of a licensed agent and are not paid based on sales commissions. Unlicensed personnel should not give advice, compare contract features, or initiate contact with clients.

### Variable Annuity Licenses

Persons selling variable contracts (variable annuities, variable life, variable universal life) are subject to dual regulation — state regulation as an insurance agent and federal regulation as a securities representative. At the federal level, this means passing the Financial Industry Regulatory Authority's (FINRA's) General Representative (Series 7) or Limited Representative (Series 6) examination. At the state level, these salespersons must hold a **Florida Variable Annuity license.** A variable annuity license does not exist by itself – a variable annuity license is valid only if the agent also holds a life insurance agent license. Recently-licensed life agents will be licensed for both life and variable annuities. Life agents who were licensed prior to 1990 did not automatically obtain the variable annuity license. For these agents, there is a separate variable annuity examination.

Agents who are licensed a particular line of insurance must also be appointed for that same line. If they remain unappointed for a line of insurance for 48 months, their license will lapse.

> For example, if you become licensed for life, health and variable annuity (2-15) license, but only are appointed for the lines of life and health, then your qualification as variable annuity agent will expire in 48 months (if there is no appointment within that time) and you will have to take the variable annuity portion of the exam again.

It is important to note that equity indexed annuities are currently treated as fixed annuities for regulatory purposes. The SEC has proposed that EIAs be subject to the same regulations as variable annuities. This proposal has been met with opposition from the National Association of Insurance Commissioners and companies that issue equity indexed annuities. Under current regulations, agents selling EIAs must be life-licensed (and appointed) — no other license is required.

### Controlled Business

Florida statutes do not permit an individual to hold an insurance agent's license if that person does not hold himself or herself out to the general public as an insurance agent but instead uses the license principally for soliciting, negotiating or procuring controlled business.

Controlled business means insurance contracts covering the agent and or members of his or her family; officers, directors, stockholders, partners or employees of a business in which he or she or a member of his or her family is engaged; or the debtors of a firm, association or corporation of which the agent is an officer, director, stockholder, partner or employee. The underlying premise is that the agent may exercise undue influence over the purchasing decisions of these people.

Agents are permitted to write contracts for clients who are considered controlled business provided that the agent writes other similar business at least equal to the amount of controlled business written within a 12-month period. Failure to write an offsetting amount of noncontrolled business can result in revocation of the agent's license.

### Ongoing agent requirements

In Florida, an agent's license does not have an expiration or renewal date – it may remain in force perpetually. An agent's license terminates if he or she allows four years to elapse without being appointed for each class of insurance listed on the license. (Appointments are discussed below.) And of course, the Department may suspend or revoke an agent's license for violations of the Insurance Code or Department rules.

Florida law requires an agent to notify the Department of Financial Services in writing, within 60 days, of any changes to his or her name, residence address, business street address, mailing address, phone numbers or email address. Change of name/address forms are available on the Department website. (www.fldfs.com)

Under Florida law any agent who has been found guilty (or plead guilty or *no lo contendere* ("no contest")) to a felony or a crime punishable by imprisonment of 1 year or more must notify the Department in writing within 30 days. This requirement applies whether the crime occurred in Florida or elsewhere; regardless of whether the crime was a violation of state or federal law. The requirement also applies without regard to whether a judgment of conviction has been entered by the court or adjudication was withheld. The agent must also notify the Department of comparable violations of foreign laws.

### Continuing education

To maintain a life or health license, agents must complete at least 24 credits of continuing education every two years in courses approved by the Department. The rules provide exceptions for persons with certain professional designations (CLUs, ChCFs, etc.). Agents licensed less than six years may earn credit in courses rated basic, intermediate or advanced. Those who have been licensed for a period of six or more years must complete only 20 credits every two years, but these credits must be in intermediate or advanced level courses. Each agent must complete, as part of his or her re-

quired number of continuing education credits every two years, a minimum of three credits of continuing education on the subject of ethics approved by the Department. Life-licensed agents must also complete three credits on the subject of suitability — which can also be used to meet the ethics requirement. This course qualifies for that suitability requirement.

An agent's continuing education compliance period is based on his or her birth date. The first compliance period ends on the last day of the agent's birth month following two years of licensure — subsequent periods end every two years thereafter.

> For example, Dawn Day passed her licensing exam on March 15, 2007. Her birthday is September 13th. Her first compliance period will end on September 30, 2009, and future compliance periods will end September 30th of every odd-numbered year thereafter.

Agents will not be able to renew their appointments, reinstate old ones or obtain new ones, if they are out of compliance with the continuing education requirements. All agents are strongly advised to maintain current continuing education and to consult the Florida continuing education law for specific requirements and exceptions.

## Agent Appointments

An appointment is defined as the authority given by an insurer to a licensee to transact insurance on behalf of an insurer. Only licensed agents may "transact insurance" in Florida, and the agent's license is only valid if at least one insurer has appointed the agent for that line of insurance. When an insurer appoints an agent, a new relationship is created that allows the agent to:

- describe the company' s insurance policies to prospective buyers and explain the conditions under which the policies may be obtained,
- solicit applications for insurance,
- collect premiums from policyowners, and
- render service to prospects and to those who have purchased policies from the company.

The authority of an agent to undertake these functions is clearly defined in a "contract of agency" (or agency agreement) between the agent and the company. Within the authority granted, the agent is considered identical with the company. The concept of "agency law" governs the relationship between an agent and the company he or she represents.

### Agent Requirements

A licensee may not transact insurance until he or she is appointed by an authorized insurer for the class of licensure held. For example, if an individual is licensed for the classes of life, health and variable annuity, and wishes to market all three types of products, he or she must be appointed by either an insurance company authorized in its certificate of authority to transact all three of these lines of business or by separate companies for each line.

> For example, if you become licensed for life and variable annuities, and Company XYZ appoints you for life only, then you will still be required to obtain an additional appointment with an appropriate company for the variable annuity portion of your license if you intend to market variable annuities.

It is the agent's responsibility to obtain the desired and appropriate appointments for his or her licensure. The agent should be involved in his or her appointment process and should be aware of the actions that are requested by an insurance company relative to his or her license. Florida law states: "Upon the expiration of a person's appointment ... the person shall be without any authority conferred by the appointment and shall not engage or attempt to engage in any activity requiring an appointment."

If a licensee loses an appointment for any line of business, his or her qualifications for that portion of his or her license will remain valid for 48 months. However, the licensee may not engage in insurance activity for that line of business until a new appointment is obtained. If the agent remains unappointed for 48 months, the license lapses.

> For example, an agent was licensed for life, health and variable annuity in 1996 and obtained appointments for all three lines. In April 2002, the company who had appointed her for variable annuities chose not to renew her appointment. Her variable annuity license remained valid (although she could not solicit variable annuity business without an appointment) until April 2006. If she did not obtain a variable annuity appointment by then, her variable annuity license lapsed and she will have to take the variable annuity portion of the exam again to be re-licensed.

Florida law requires insurers to conduct a background check prior to appointing an agent. Specifically the insurer must inquire as to the criminal history, credit standing and moral character of each appointee. After the background check, the company will file the appointment paperwork, plus filing fee, with the Department of Financial Services. Appointments need to be renewed every two years. If the agent fails to comply with continuing education requirements, the Department will not allow renewal.

### Premium payments

Under the law of agency, an agent is the lawful representative of the principal, which in this case is the insurance company. Thus, the payment of premiums or other sums to the agent is the same as paying them to the insurance company. Because of this, the agent has a fiduciary responsibility to turn the funds over to the insurance company immediately, and not to use them for his or her own purposes. If held by the agent, these funds should be held in a segregated account, i.e., separate from personal funds. Converting those funds to personal use is a crime known as embezzlement or conversion. The severity of the crime depends on the amount of funds that were misapplied.

In addition, Florida law requires agents to keep records for at least three years if the transaction pertains to premium payments. The Office and the Department may examine these records at any time.

### Commissions

Generally speaking, agents will show proposals for companies that have appointed the agent. Agents may, however, show proposals for other companies – provided the agent is licensed and appointed for that particular line of insurance. The agent may furnish materials and show proposals for any company authorized to sell that line in Florida. However, if the agent actually writes the business, the company must formally appoint the agent when the agent submits the application. Furthermore, the company may not pay the agent a commission until the appointment is actually issued.

Agents may split their commissions with another agent who is Florida-licensed and appointed for that line of insurance. Splitting of commissions with non-licensed persons is considered "rebating", which is permitted only under tightly regulated circumstances.

> For example, John Williams holds a life license and is an appointed life agent. While he feels comfortable discussing traditional life insurance and fixed annuities with his clients, when it comes to variable annuities he refers his clients to Maria Perez, a licensed life and variable annuity agent. Maria cannot pay John a referral fee or split the commissions on variable products with John, since he does not hold a variable annuity license. (She could, however, split a commission on an equity indexed or fixed annuity with John, as he is licensed and appointed for that line of business.)

Insurance companies, in general, are limited in paying commissions to licensed individual agents only. Insurance companies, however, may pay commissions to an incorporated insurance agency that is properly registered or licensed with the Department of Financial Services. State law requires all employees, officers and directors of these agencies who transact insurance business to hold a valid Florida agent license.

## Insurance Agencies

For years, Florida was unique in that it did not require insurance agencies to obtain a license prior conducting insurance business. The federal Financial Services Modernization Act of 1999 required states to implement standardized licensing procedures to foster reciprocity of agent and agency licenses between states. As a response to that Act, Florida now requires insurance agencies to be licensed. An agency is defined as a location from which insurance business is transacted. Typically it is the business office of an agent, but it also could be the agent's home if business is solicited from there. An agency may involve many agents transacting insurance business at that location or it might be a one-agent office. Agencies may be organized as a sole proprietor, a partnership, corporation or other business entity acting under its own name or a trade name.

Effective October 1, 2006, agencies must be either licensed or registered in Florida. The licensing process requires an agency to submit an application. The application discloses the name of the agency, the owners or officers of the agency and their residential addresses, the location of each office that transacts insurance business, and the name of a full-time agent who supervises each location. The agency must also file the fingerprints of the all owners/partners/officers/directors with

the Department (if those fingerprints are not already on file). The president and secretary of the corporation sign applications on behalf of incorporated agencies; in the case of unincorporated agencies the owner or partners sign the application.

Some agencies may be registered, instead of licensed. Agencies in existence prior to 2003 that are completely owned by Florida-licensed insurance agents may choose to register instead of apply for licensing. (Branch offices of broker-dealers in existence before 2003 that are subject to FINRA regulation may also choose to register.) The application for registration is the same as for licensing, but fingerprints are not required as part of the process. Whereas an agency license must be renewed periodically, registration is perpetual (unless the agency or its owners/officers commit violations of the Insurance Code). An agency license provides Florida agencies with reciprocity for licensing in other states; registration does not. If a registered agency no longer qualifies for registration, it must become licensed. For example, if one of the owners of the registered agency is no longer licensed as an agent in Florida, or one of the owners violates the Insurance Code, the agency must become licensed.

The penalty for failing to apply for agency licensing is $10,000; the penalty is $5,000 in the case of registration. Unlicensed or unregistered agencies may not transact insurance business in Florida, and insurance companies cannot pay commissions to unlicensed or unregistered agencies. Licensed or registered insurance agencies may split their commissions with licensed agents in the office. Agencies may not pay fees or other compensation to an unlicensed person for referrals if that fee is dependent on the referral purchasing an insurance product. Each agency must prominently display its license or registration so that it is clearly visible to the public. Violations of the agency law are third-degree felonies – and may result in the revocation or suspension of the agency license. During an agency's suspension or revocation the Department may also suspend or revoke the license or registration of other agencies under the same management, ownership or control. New licenses will not be granted to agencies having similar management, ownership or control as a suspended or revoked agency.

[There are some inconsistencies and ambiguity in this new law. It may be subject to revision in upcoming Legislative sessions. Agents should keep abreast of any changes.]

## Financial Institutions

The marketplace for annuities has expanded as insurance companies developed new distribution channels. The federal Financial Modernization Act reduced barriers between insurance companies and other financial institutions. And as a result of two U.S. Supreme Court decisions, banks and other financial institutions are allowed to sell all types of insurance anywhere in the state. The case of *NationsBank of North Carolina v. Variable Annuity Life Insurance Co.* permitted the sale of annuities by banks. The case of *Barnett Bank of Marion County, N.A. v. Nelson, Florida Insurance Commissioner* permitted the sale of all other lines of insurance. Agents affiliated with or employed by financial

institutions are allowed to solicit and market all types of insurance subject to specified consumer protections and disclosures required by state law.

Florida law requires that financial institutions conduct insurance transactions only through Florida-licensed insurance agents representing Florida-authorized insurers. Agents who are employees or affiliated with financial institutions are licensed and regulated the same as any other agent.

Florida law also imposes additional consumer protections when financial institutions sell insurance — specifically the law:

- Prohibits the rejection of an insurance policy required in connection with a loan because an agent unaffiliated with the bank sold it.
- Prohibits the imposition of extra charges on insurance policies purchased from unaffiliated agents required in connection with a loan.
- Prohibits misrepresentations regarding the insured or guaranteed status of any insurance product.
- Prohibits the release of insurance information to third parties without the express consent of the consumer; or unless the consumer has been given clearly and conspicuously in writing the opportunity to object to such use of the information.
- Prohibits tying insurance products to loan arrangements and restricts a loan officer from selling insurance for a loan in which the same loan officer is involved in the application, solicitation or closing of the loan.
- Requires the disclosure, prior to any insurance sale, that insurance products are a deposit; not insured by the FDIC; not guaranteed by the financial institution or its subsidiaries or affiliates; and where appropriate, involves investment risk, including loss of principal.
- Requires the disclosure, when insurance is mandated in connection with a loan, that the purchase of insurance from an agent who is unaffiliated with the bank does not affect the loan decisions or the credit terms in any way.
- Requires the completion of credit and insurance transactions through separate documents.
- Prohibits the inclusion of insurance premiums in a credit transaction without the express consent of the customer.
- Prohibits the use of the name or logo of a financial institution or its affiliates or subsidiaries when marketing or soliciting existing or prospective customers if such marketing materials are used without the written consent of the financial institution and in a manner that would lead a reasonable person to believe that the material or solicitation originated from, was endorsed by or is related to the financial institution.

## Annuity Disclosure Procedures

Variable annuities originated as a supplement to fixed dollar annuities. Fixed annuities provide safety of principal but are subject to inflation risk. Variable annuities provide a hedge from inflation but are subject to investment risk. The two types of annuities complement each other. When soliciting variable annuities, Florida agents must inquire as to the prospect's sources of income. The purpose of this inquiry is to call attention to the client's overall financial situation. It does not require or prohibit any other action on the part of the agent or prospect. The agent must simply ask the question.

### Prospectus

Variable insurance products – variable annuities, variable life, and variable universal life – are treated as securities under federal securities laws. A "prospectus" must accompany sales presentations of these products. This document is prepared and furnished by the insurance company and reviewed by the SEC. A prospectus contains information about the nature and purpose of the insurance or annuity plan, the separate account and the risk involved. It is a primary source of information for the prospect. All other materials, such as direct mail letters, brochures and advertising variable products also must have prior approval by the SEC.

### Buyers Guides and Contract Summary

Under Florida's General Solicitation Law, a Buyer's Guide and a Contract Summary must accompany sales of all types of annuities. The Buyer's Guide is a generic brochure designed to provide consumers with basic information regarding the purchase of insurance and annuities. The Contract Summary will summarize the details of the annuity contract, set forth in a format consistent with NAIC guidelines. The Contract Summary will contain information on the specific type of contract and any applicable riders, premiums, dividends, benefit amounts, cash surrender values, charges and fees, etc.

### Replacement

Situations will arise in which a client will wish to replace or exchange an existing contract for a new one offered by the agent. While replacement is a legitimate activity, there have been problems in the past with agents who encourage contract exchanges as a way to generate commissions for themselves. Agents and insurers must make several disclosures whenever an existing policy or contract will lapse or be significantly reduced in value.

Florida's disclosure requirements, as well as those required by other regulators, will be discussed in greater detail in Chapter 6.

## Other Regulatory Organizations

### National Association of Insurance Commissioners

All state insurance commissioners or directors are members of the National Association of Insurance Commissioners (NAIC). This organization has standing committees that work regularly to examine various aspects of the insurance industry and to recommend appropriate insurance laws and regulations. The NAlC has four broad objectives:

- to encourage uniformity in state insurance laws and regulations;
- to assist in the administration of those laws and regulations by promoting efficiency;
- to protect the interests of policyowners and consumers; and
- to preserve state regulation of the insurance business.

The NAIC has been instrumental in developing guidelines and model legislation that help ensure that the insurance industry maintains a high level of public trust by conducting its business competently and fairly. This group also develops standards for policy provisions, helping ensure that policies become more uniform across the country. The NAIC has no enforcement powers. Notable among the NAIC's accomplishments was the creation of the Advertising Code and the Unfair Trade Practices Act, which have been adopted in some form by every state.

#### *Advertising Code*

A principal problem facing states in the past was regulating misleading insurance advertising and direct mail solicitations. Many states, including Florida, now subscribe to the Advertising Code developed by the NAIC. The Code specifies certain words and phrases that are considered misleading and are not to be used in advertising of any kind. The Advertising Code requires full disclosure of policy renewal, cancellation and termination provisions. Other rules pertain to the use of testimonials, statistics, special offers and the like.

#### *Unfair Trade Practices Act*

The McCarran-Ferguson Act exempts insurance activities from federal anti-trust laws – "to the extent they are governed by state law." Shortly after passage of McCarran Ferguson, each state passed laws to address this concern and preserve state regulation of insurance. Most jurisdictions, including Florida, have adopted some version of the NAIC's Model Unfair Trade Practices Act. This act gives state regulatory officers the power to investigate insurance companies and producers, to issue cease and desist orders and to impose penalties on violators. The act also gives officers the authority to seek a court injunction to restrain insurers from using any methods believed to be unfair or deceptive. Included in the context of unfair trade practices are misrepresentation and false advertising, coercion and intimidation, unfair discrimination, and inequitable claims settlements.

### *Other Model Laws*

The NAIC has been instrumental in crafting model legislation that most states have enacted. Recently Congress has relied on the NAIC to promote greater nationwide uniformity in the fields of Medicare supplemental insurance, long-term care policies and state reciprocity of agent licenses. One recent NAIC Model law of is of particular interest to agents selling annuities: the Suitability in Annuity Transactions Model Regulation, which addresses agent training and supervision. This model law focuses on "senior consumers" and requires agents to adequately document the suitability of their recommendations to those age 65 or older. The NAIC is in the process of expanding the scope of this law to cover all consumers regardless of age. To date, Florida has adopted a version of the "senior customer" version of this model act — the details of Florida's law are covered in Chapter 6.

## NAIFA and NAHU

The National Association of Insurance and Financial Advisors (NAIFA) and the National Association of Health Underwriters (NAHU) are organizations of life and health insurance agents that are dedicated to supporting the life and health insurance industries and advancing the quality of service provided by insurance professionals. Each organization issues a Code of Ethics that stresses the high professional duty expected of underwriters toward their clients, as well as to their companies, and emphasizes that only by observing the highest ethical balance can conflict between these two obligations be avoided.

**NAIFA Code of Ethics**

"Those engaged in offering insurance and other related financial services occupy the unique position of liaison between the purchasers and the suppliers of insurance and closely related financial products. Inherent in this role is the combination of professional duty to the client and to the company as well. Ethical balance is required to avoid any conflict between these two obligations.

Therefore, I Believe It To Be My Responsibility:

- To hold my profession in high esteem and strive to enhance its prestige.
- To fulfill the needs of my clients to the best of my ability.
- To maintain my clients' confidences.
- To render exemplary service to my clients and their beneficiaries.
- To adhere to professional standards of conduct in helping my clients to protect insurable obligations and attain their financial security objectives.
- To present accurately and honestly all facts essential to my clients' decisions.
- To perfect my skills and increase my knowledge through continuing education.
- To conduct my business in such a way that my example might help raise the professional standards of those in my profession.
- To keep informed with respect to applicable laws and regulations and to observe them in the practice of my profession.
- To cooperate with others whose services are constructively related to meeting the needs of my clients.

## FAIFA

The Florida Association of Insurance and Financial Advisors (FAIFA) fulfills a similar function to NAIFA in Florida. FAIFA's Code of Ethics specifically addresses misrepresentations, twisting, rebating, and defamation. FAIFA's Code of Ethics has been adopted into the Department of Financial Services' rules.:

**69B-215.210 Scope.**

The Business of Life Insurance is hereby declared to be a public trust in which service all agents of all companies have a common obligation to work together in serving the best interests of the insuring public, by understanding and observing the laws governing Life Insurance in letter and in spirit by presenting accurately and completely every fact essential to a client's decision, and by being fair in all relations with colleagues and competitors always placing the policyholder's interests first.

**69B-215.215 Twisting.**

Twisting is declared to be unethical. No person shall make any misleading representations or incomplete or fraudulent comparison of any insurance policies or insurers for the purpose of inducing, or tending to induce, any person to lapse, forfeit, surrender, terminate, retain, or convert any insurance policy, or to take out a policy of insurance in another insurer.

**69B-215.220 Rebating.**

Rebating is declared to be unethical. Except as otherwise expressly provided by law, no person shall knowingly permit or offer to make or make any contract of life insurance, life annuity or disability insurance, or agreement as to such contract other than as plainly expressed in the contract issued thereon, or pay or allow, or give or offer to pay, allow, or give, directly or indirectly as an inducement to such insurance, or annuity, any rebate of premiums payable on the contract, or any special favor or advantage in the dividends or other benefits thereon, or any valuable consideration or inducement whatever not specified in the contract.

**69B-215.225 Defamation.**

Defamation is declared to be unethical and defined as making, publishing or circulating any oral, written or printed statement which is false, or maliciously critical of or derogatory to the financial condition of any insurance company, or which is calculated to injure any person engaged in the business of life insurance, and this practice is declared to be unethical.

**69B-215.230 Misrepresentations.**

(1) Misrepresentations are declared to be unethical. No person shall make, issue, circulate, or cause to be made, issued, or circulated, any estimate, circular, or statement misrepresenting the terms of any policy issued or to be issued or the benefits or advantages promised thereby or the dividends or share of the surplus to be received thereon, or make any false or misleading statement as to the dividends or share of surplus previously paid on similar policies, or make any misleading representation or any misrepresentation as to the financial condition of any insurer, or as to the legal reserve system upon which any life insurer operates, or use any name or title of any policy or class of policies misrepresenting the true nature thereof.

(2) No person shall make, publish, disseminate, circulate, or place before the public, or cause, directly or indirectly, to be made, published, disseminated, circulated, or placed before the public, in a newspaper, magazine, or other publication, or in the form of a notice, circular, pamphlet, letter or poster, or over any radio or television station, or in any other way, any advertisement, announcement or statement containing any assertion, representation or statement with respect to the business of insurance or with respect to any person in the conduct of his insurance business, which is untrue, deceptive or misleading.

## Insurance Marketplace Standards Association (IMSA)

The purpose of the Insurance Marketplace Standards Association (IMSA) is to promote high ethical standards in the sale of individual life insurance, annuity products and long-term care insurance by its member companies. With more than 200 voluntary member insurance companies, IMSA demonstrates the firm commitment to ethical market conduct that a large portion of the insurance industry has made. IMSA delineates its standards of ethical market conduct through six principles: each of which is supported by several codes. In order to join IMSA, an insurance company must go through two assessments (one internal and one third-party) to demonstrate that it upholds these codes. This process must be repeated every three years. The principles and codes demand that each member company promote ethical standards to its producers.

## Rating Services

While technically not a regulatory body in the traditional sense, rating services are private companies that review the financial strength and stability of an insurance companies. These are two vitally important factors to potential insurance buyers and to insurance companies themselves. By publishing their assessment of financial strength, the ratings organizations help market forces guide insurance company decisions and operations.