Senior Suitability

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Annuities at their most basic level are a simple concept to grasp — but as the old saying goes: the devil is in the details. Each contract has its own the unique set of provisions, which complicates the advisor's task of recommending suitable contracts for his or her client's unique situation. As a result, many clients have been sold annuity contracts that do not meet their needs. Over the years, the annuity industry has developed new, more complicated types of contracts, such as equity indexed annuities, and introduced new benefits that are not easily understood, such as enhanced living and death benefits. While these new products can offer prospects a greater range of options to meet their financial needs, they often can confuse clients and agents alike. Government regulators at the state and federal level have noted this evolution of product design and its adverse impact on clients. As a result, they have imposed additional regulations on the sale of annuities. The purpose of these enhanced regulations is to protect consumers and aid advisors in their search for suitable investment recommendation.

This chapter will explore two new amendments to Florida's Senior Consumer Law: ***the Seibel Act,*** passed in 2008, and the ***Safeguard Our Seniors Act,*** signed by the governor in 2010. As we'll see there is an exemption in this law for transactions governed by the Financial Industry Regulatory Authority (FINRA). FINRA rules and state law, to some extent, overlap each other, but sometimes neither may not apply to a particular transaction. Ethical advisors will want to follow the general principles of these regulations regardless of whether the strict language of the rules applies to a particular situation or not.

Regulatory Framework

Before we explore these two regulations, a brief review of the regulatory framework and conflicting jurisdictions governing annuities is in order. Fixed annuities, including equity indexed annuities, fall under the purview of state insurance authorities. Variable contracts fall under both state and federal jurisdictions — state insurance commissioners regulate the variable contract itself as an insurance product, the SEC claims jurisdiction over the separate, subaccounts within the contract as an investment product. The SEC, in turn, delegates oversight of the sale of variable annuities to FINRA (Financial Industry Regulatory Authority). As a result, state laws govern the sale of fixed annuities and variable annuities; FINRA governs the sale of variable annuities only.

In 2008, the SEC proposed a new Rule (151A) that would have treated equity indexed annuities (EIAs) as variable contracts — subjecting EIAs to dual jurisdiction. That proposal met significant opposition by the National Association of Insurance Commissioners (who wish to preserve sole state regulation) and the annuity industry. In June 2010, a federal court found the SEC's analysis of the EIA regulations to be flawed, and a few weeks later, Congress passed a financial industry reform bill (Dodd-Frank) that permanently classified most EIAs as fixed annuities, and therefore subject to state regulation only.

Seibel Act of 2008

In the late 1990s, state regulators across the country began to seriously address the sale of fixed annuities to "senior consumers". These laws typically required advisors to make minimum inquiries of their older client as to their financial situation and needs. Florida enacted these consumer protections, based on the NAIC's "Senior Protection in Annuity Transactions Model Law", in 2004. Analysis by the Department of Financial Services found that due to vague wording this law was ineffective. In 2008, the Florida legislature strengthened its language. This was in response to instances in which elderly clients were sold annuities that were deemed unsuitable for their needs — in particular, highly-illiquid contracts. One elderly couple from Venice, both in their eighties, were sold $600,000 in annuities with surrender charge periods that lasted longer than their life expectancies. The updated state law, known as the "John and Patricia Seibel Act" is named for them. The primary focus of the Seibel Act is to strengthen the protections for elderly purchasers of annuities — but the law also contains several other important features (and these are discussed in Chapter 4).

Safeguard Our Seniors Act of 2010

In the waning days of its 2010 session, the Florida Legislature passed the Safeguard Our Seniors Act, which strengthens senior investor fraud laws in Florida. The provisions of this law are the result of hundreds of "town hall" meetings conducted statewide by the Department of Financial Services. The governor signed this bill into law in May 2010, and its provisions become effective January 1, 2011.

The Safeguard our Seniors Act does the following:

- Increases the financial penalty for the willful act of "twisting" or "churning" of an annuity to a maximum of $75,000, which is intended to be a strong disincentive to this unlawful behavior.
- Limits the period of a surrender charge for an annuity sold to a senior consumer (age 65 or older) to 10 years and limits the surrender charge to 10 percent.
- Extends the "free look" period for the purchase of an annuity by a senior consumer from 14 to 21 days.
- Authorizes the Department of Financial Services (DFS) to require an agent to make monetary restitution to a senior consumer harmed by a violation of the insurance code under certain circumstances.
- Includes a third-party marketer that aids and abets an insurance agent in the violation of the Insurance Code involving an annuity sale to a senior consumer as an affiliated party of the insurance agent, bringing that marketer under the regulatory authority of the DFS.

- Gives the DFS authority to take license disciplinary action against an agent who has been disciplined under his or her securities broker-dealer license or a related license.
- Prohibits the DFS from issuing a license to a former licensee who has had his or her license revoked resulting from the solicitation or sale of an insurance product to a senior consumer.
- Extends the prohibition on a life insurance agent being the beneficiary of a life insurance policy by including the agent's family members within the prohibition and by prohibiting the agent from serving as a guardian, trustee, or having power of attorney over the insured.
- Requires an insurer to provide a cover sheet attached to the policy when an annuity is issued, informing the purchaser about the free look period and about how to contact the insurer and the DFS if they have questions about the annuity.
- Allows the use of video depositions in administrative hearings involving a senior consumer and requires compliance with the Rules of Civil Procedure.

Florida's Senior Consumer Law

The initial NAIC model enacted in Florida was intended to create standards for recommending the purchase or exchange of annuities to consumers who are 65 or older, specifically that agents and insurers must have "reasonable grounds" for recommending annuities to seniors. The intent of the Seibel Act is to replace this subjective standard with a more objective standard. The initial law was ineffective because regulators needed clear and convincing evidence, not to prove that a particular transaction was indeed suitable for the client, but whether the agent reasonably believed it was. The new standard now requires an insurer or agent, who recommends purchase or exchange of an annuity to a senior consumer, to have **"an objectively reasonable basis for believing the recommendation is suitable."** A "senior consumer" is defined as an individual purchaser age 65 or older — and the case of joint purchasers, if either is 65 or older. A "recommendation" is an annuity transaction (purchase or exchange) that is based on the agent's advice. "Annuities" are defined in this law as individually solicited fixed, variable and equity indexed contracts, whether identified as individual or group contracts. For full text of Florida Statutes, Section 627.4554 .

Disclosure requirements

The Seibel Act specifies the minimum information that must be obtained from a senior consumer and requires use of a form designed by the Department of Financial Services. (Form DFS-H1-1980) At a minimum, agents must ascertain the client's:

- age and gender of the purchaser(s),
- number and age of any dependents,
- investment objectives,
- risk tolerance,
- existing assets,
- annual income,

- tax status,
- liquid net worth,
- future financial concerns and needs (medical expenses, long-term care, bequests to heirs, projected retirement age, etc.),
- intended use for the annuity, and
- source of funds to be invested in the annuity.

The agent must also note any other information he or she used or considered in making the recommendation.

The agent must forward a copy of the completed questionnaire to the issuing company (or its authorized third party, such as a managing general agent or insurance agency) within 10 days. A copy of the completed questionnaire must be given to the client no later than the time the contract documents are delivered to the client.

Any recommendations given by the agent must be suitable based on the information the client provides to the agent at the time of purchase. Chapter 3 analyzes the factors that go into a determination of suitability.

The agent is absolved of the suitability requirements if the client refuses to give the agent the required information, the client provides false or incomplete information, or the client chooses to purchase annuities against the recommendation of the agent. If the client refuses to provide the required information, the agent or insurer must, before execution of a transaction, document the client's refusal on a form approved by the Department — and obtain the client's signature. This form will disclose to the client that failure to provide the required information may limit the protections offered under this law.

If the client currently holds one or more annuity contract, the agent must also determine:

- the type of contract(s) the client holds,
- the issue dates(s),
- maturity or annuitization date(s),
- allocation of funds within the contract (for variable annuities),
- applicable surrender charges,
- any contract riders or endorsements, and
- liquidity within the contract(s) — prior to maturity and at maturity.

If the agent recommends a transaction to replace or exchange an annuity, the insurer or agent must provide a written comparison of the existing contract and the proposed contract, on an approved form. (Form DFS-H1-1981) This disclosure form will compare:

- the benefits, terms, and limitations between the annuity contracts,
- any fees and charges between the annuity contracts.

This replacement form must also contain a statement by the agent describing the basis for recommending the exchange, including the overall advantages and disadvantages to the consumer if the recommendation is followed. The agent must also disclose other information used or considered to be relevant by the insurance agent or the insurer in making his or her recommendation to replace the annuity contract.

As with the basic questionnaire, a copy of the replacement comparison form must be forwarded to the proposed issuing company within 10 days, and to the client no later than delivery of the contract documents.

Agents who recommend the purchase of an annuity or propose to replace an annuity must disclose to the client that such actions may have tax consequences and that the applicant should contact his or her tax advisor for more information. The law does not require that this disclosure be in writing, or on any particular form, but cautious agents will want to permanently document this disclosure.

Supervision

Agents, insurance agencies and issuing companies must put in place systems to assure agents make suitable recommendations and comply with this law. At a minimum, this requires a set of written procedures and periodic audits to assure compliance. Often, issuing companies will contract with third parties — such as managing agents or insurance agencies — to market their annuity products. Issuers can also rely on these third parties to implement appropriate supervisory systems on their behalf to assure that agents under the third party's control follow the law when selling the issuer's products. When issuing companies rely on third parties to fulfill this compliance role, the issuing company must make adequate inquiries into the third party's supervisory efforts and take whatever actions are necessary to assure that the third party is adequately meeting its compliance function. Issuing companies may meet this obligation by periodically auditing third parties who represent the company, or obtaining an annual statement from the senior manager of the third party that the third party is continuing to fulfill its supervisory role. When requested by the issuing company, managers of third parties must promptly provide a certification of continued compliance (or statement of non-compliance, if that is the case). Industry groups, such as the Insurance Marketplace Standards Association (IMSA), have formed voluntary certification systems for third party supervisors. Issuing companies and managing agents are only required to monitor agent compliance with the suitability requirements for products offered by that company or agency — they have no supervisory responsibility for products offered by other companies or agencies.

The law mandates that certain documents be retained for at least five years. The law simply states that issuing companies, agents, and third parties retain "records of the information collected from the senior consumer and other information used in making the recommendations" — this would include annuity applications, questionnaires, illustrations, customer correspondence, account review documents and account statements

The prior law was vague as to who — agents, companies or third parties — must retain supporting documentation. The new law places the responsibility on all three. The annuity company can offer (but is not required) to maintain these records on behalf of its agents. Original records may be retained, or the records can be kept in any other media (photographic, digital, etc.) so long as a legible reproduction of the original is maintained.

The Safeguard Our Seniors Act extends Department of Financial Services jurisdiction over third-party marketing supervisors that aid and abet agents in violating Florida's Senior Consumer Law.

Mitigation

One particularly important amendment to the new suitability law gives the Department of Financial Services (which regulates agents) and the Office of Insurance Regulation (which regulates insurers) the power to correct, or "mitigate" unsuitable annuity purchases. The Office of Insurance Regulation can force an issuing company to rescind inappropriate contracts — in effect, canceling the contract and refunding the client's money. The amount of the refund is the greater of the client's investment or the accumulated value in the contract. The Department of Financial Services may take "any reasonably appropriate corrective action" to undo harm to a senior client by an agent's recommendations. The law also allows regulators to waive penalties for companies and agents that take prompt actions to correct harm caused by unsuitable recommendations. (The offer to waive penalties is an incentive to get companies and agents to "do the right thing" to make the client whole as quickly as possible.)

This new power to rescind annuity contracts is quite broad. Other regulators in the state may pursue rescissions through the court system, but the unilateral power of the OIR to rescind contracts is unprecedented in Florida.

Agents or insurers who fail to meet the requirements of this law are subject to penalties and enforcement action by the Department of Financial Services or Office of Insurance Regulation. This law does not give clients or others the right to sue privately for violations of these rules — although clients may pursue other claims such as breach of fiduciary trust or negligence in private, civil legal proceedings.

The updated law includes a new provision to protect issuing companies from actions taken by unrelated, unauthorized parties:

> "Nothing in this section shall subject an insurer to criminal or civil liability for the acts of independent individuals not affiliated with that insurer for selling its products, when such sales are made in a way not authorized by the insurer."

A new provision under The Safeguarding Our Seniors Act authorizes the Department of Financial Services to require an agent to pay monetary restitution to a senior consumers if the agent illegally withholds, converts or misappropriates funds belonging to a senior consumer during an annuity transaction. Employers of agents and managing general agents must take reasonable correction action to assist senior consumers harmed by agents under their supervision.

Scope

Generally speaking the new disclosure requirements apply to the sale of annuities to individual, senior customers (age 65 or older). The law specifically exempts certain transactions from these requirements:

- sales resulting from direct mail solicitation in which no recommendation is made by the agent, or
- contracts sold to an employer's qualified retirement plan (plans covered by ERISA, 401(k) plans, etc.), tax-sheltered annuities sold to non-profit organizations and church plans (403(b) plans), or government-provided retirement plans (457 plans), and
- sales to employer-provided non-qualified deferred compensation plans.

Note that annuities sold to Individual Retirement Accounts must follow the suitability requirements for that individual — if the individual is age 65 or older.

FINRA Exception

One odd legislative note about the updated law: The prior state statute carved out an exception to the suitability rules for sales of variable annuities by agents who were affiliated with broker-dealers regulated by the National Asssociation of Securities Dealers (NASD). All agents selling variable annuities needed to be registered as a representative of a broker-dealer that belonged to the NASD — so this exception effectively put sales of all variable annuities outside the scope of this state law. The premise for that exception was that the NASD had its own suitability requirements, and the state was simply deferring to the NASD's requirements for the sale of variable annuities. In 2007, the NASD merged with the NYSE's regulatory arm to create the Financial Industry Regulatory Authority (FINRA).

In the legislature's infinite wisdom, when they updated the language in 2008, they extended this exception to cover the sale of any annuity (fixed or variable) by a FINRA affiliated agent. While FINRA has suitability rules for the sale of variable annuities, it has no jurisdiction over fixed annuities (including indexed annuities). This leaves a possible loophole for the sale of fixed annuities by FINRA-affiliated agents. It is possible to read the new law in such a way as to exempt any FINRA affiliated agents from compliance with this law:

> "Any person who is registered with a member of the Financial Industry Regulatory Authority, who is required to make a suitability determination, and who makes and documents such determination is deemed to satisfy the requirements under this section for the recommendation of annuities. "

The key phrase is: "who is required to make a suitability determination". FINRA representatives are, generally speaking, prohibited from making unsuitable recommendations. Is that general principle the same as making a "suitability determination"? If it is, then FINRA affiliated reps need not follow the new state suitability rules when selling any type of annuity. If one argues that

FINRA has no jurisdiction over fixed annuities and therefore it cannot require a suitability determination for sales of fixed annuities — this exception then applies only to variable annuities, and state law applies to the sale of fixed annuities at FINRA institutions. (This was the original law's language and probably the legislature's intent when it updated the language.) It is interesting to note, however, that the title of this exception was changed too — from "Application to Variable Annuities" to "Application to Annuities" — so perhaps the legislature intended to expand this exemption to the sale of all annuities by FINRA reps after all.

State regulators jealously guard their jurisdiction. Cautious agents affiliated with FINRA broker-dealers would be wise to follow the original law's intent — apply FINRA rules to the sales of variable annuities and comply with state suitability requirements when it comes to recommendations of fixed annuities (including EIAs) to senior consumers.

Summary of FINRA’s Suitability Requirements:

- FINRA rules apply to the purchase or exchange of deferred variable annuities only
- FINRA rules apply to the purchase or exchange by clients of any age
- Agents must document basic information (similar to that required by state law).
- Agents must obtain approval by a principal of their firm prior to executing the purchase or exchange
- Principals have 10 days to approve or deny the purchase or exchange
- Broker-dealer must train and supervise their registered representatives
- Broker-dealers must retain supporting documentation.

NAIC and Annuity Suitability

The National Association of Insurance Commissioners works to promote standardized state regulations nationwide. It does this by drafting "model laws" that can be the basis of actual legislation adopted by the states. Much of Florida's Insurance Code is based, at least in part, on NAIC model laws. Annuity suitability is no exception. The NAIC's initial efforts regarding annuity suitability were aimed at protecting older consumers — and the first NAIC model law on suitability, *Senior Protection in Annuity Transactions Model Regulation*, was adopted by the NAIC in 2003. This model law covers the sales of annuities to consumers aged 65 and older. Florida's initial suitability legislation in 2004 was based on that model law. Other states have pursued other forms of investor protections — some states extended the annuity protections to consumers of all ages, others extended suitability provisions to the sale of annuity and non-annuity insurance products, other states followed a model law drafted by the North American Securities Administrators Association (NASAA).

In 2006, the NAIC drafted and approved a new model law, *Suitability in Annuity Transactions Model Regulation* that extends suitability protections to sales of annuities to consumers of all ages. When Florida updated its original suitability law in 2008, it faced a choice — and the Legislature chose to continue to apply the suitability requirements only to the sale of annuities to senior consumers. With intense focus on this issue, it is quite possible that Florida, in the future, will join other states that expand that requirement to the sale of annuities to all consumers. There certainly is nothing unethical if a Florida agent wishes to apply the senior rules to younger clients — even if Florida law does not require it. The disclosure requirements in Florida's senior law offer agents a convenient checklist of questions to ask prospects of any age before making a fixed annuity recommendation. FINRA's requirements make no distinction based on age when it comes to recommendations for variable annuities. FINRA and the NAIC seem to agree that suitability requirements should be "ageless".