The COMMITTEE of ANNUITY INSURERS

1455 Pennsylvania Avenue NW, Suite 1200, Washington, DC 20004

August 7, 2017

FILED ELECTRONICALLY

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attention: Fiduciary Rule Examination (RIN 1210-AB79)
U.S. Department of Labor
200 Constitution Avenue, N.W.
Room N-5655
Washington, DC 20210

Re: Fiduciary Rule Request for Information, RIN: 1210-AB79

On behalf of the Committee of Annuity Insurers (the "Committee"), we write to follow up on our July 21, 2017, letter responding to the Department of Labor's (the "Department's") Request for Information ("RFI") on the Fiduciary Rule.[1]

The Committee is a coalition of life insurance companies formed in 1981 to participate in the development of federal policy with respect to annuities. The Committee's 29 member companies represent more than 80% of the annuity business in the United States and are among the largest issuers of annuity contracts to IRAs and employer-sponsored retirement plans. A list of the Committee's member companies is attached as Appendix A.

I. Data on the Fiduciary Rule's Effect on Americans Saving for a Secure Retirement

Now that the Fiduciary Rule has gone into effect, it is critical for Department officials to understand the effects that the Fiduciary Rule is already having on access to annuities and guaranteed lifetime income in retirement. In our April 2017 comment letter, we cataloged the data available at that time to demonstrate these effects. A sampling of those data is provided below:

- Data from the LIMRA Secure Retirement Institute showed that variable annuity sales in 2016, in anticipation of the Fiduciary Rule, declined by more than 25%.[2]

[1] For purposes of this letter, "Fiduciary Rule" means the new regulation itself (DOL Reg. § 2510.3-21) and the related new and amended exemptions.

[2] Greg Iacurci, *Department of Labor's fiduciary rule blamed for insurers' massive hit on variable annuity sales*, INVESTMENT NEWS (Mar. 28, 2017),

Importantly, this decline occurred for all major variable annuity issuers. When LIMRA conducted its study, it forecasted another decrease in the sale of variable annuities by 10-15%, and if the Fiduciary Rule went into effect, by 20-25%.[3]

- LIMRA data also showed that, in the first three quarters of 2016, before the Fiduciary Rule began to impact the industry, fixed annuity sales hit a record-breaking $117.4 billion, 14% higher than 2015 levels and nearly $7 billion higher than 2009 (when sales were last at their highest). But then, in the fourth quarter of 2016, fixed annuity sales fell 13% from the prior year.[4]

- ThinkAdvisor reported in December 2016 that "U.S. variable annuity and fixed indexed annuity sales are expected to decline by at least 10% through 2018 as the industry struggles to adapt to upcoming regulations put forth by the Department of Labor, according to Cerulli Associates. The Boston-based global research and consulting firm states in its research that while insurers are trying to grow their businesses in the face of obstacles regarding 'benefit hedging, product derisking, and the sustained low-interest-rate environment,' *Cerulli sees the biggest challenge for the foreseeable future is DOL's fiduciary rule*, formally called the conflict of interest rule."[5]

- In the same article, ThinkAdvisor reported that "[t]he Insured Retirement Institute found that industrywide annuity sales in the third quarter [of 2016] totaled $51.3 billion, an 8.2% drop from sales of $55.9 billion during the second quarter of 2016, and a 12.3% decline from $58.5 billion in the third quarter of 2015."[6]

- In November 2016, CoreData Research released a study that included the finding that "[a]bout a third (32%) [of a group of 552 U.S. financial advisers] believe shifting away from certain products, such as annuities and non-traded REITs, is one of the biggest challenges posed by the fiduciary rule."[7]

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http://www.investmentnews.com/article/20170328/FREE/170329922/department-of-labors-fiduciary-rule-blamed-for-insurers-massive-hit?utm_source=Morning-20170329&utm_campaign=investmentnews&utm_medium=email&utm_visit=24334.

[3] *Id.*

[4] News Release, LIMRA, LIMRA Secure Retirement Institute: Fixed Annuity Sales Hit Record $117.4 billion in 2016 (Feb. 21. 2017), http://www.limra.com/Posts/PR/News_Releases/LIMRA_Secure_Retirement_Institute__Fixed_Annuity_Sales_Hit_Record_$117_4_billion_in_2016.aspx.

[5] Melanie Waddell, *Annuity Sales to Plunge Under DOL Fiduciary Rule: Cerulli*, THINKADVISOR (Dec. 15, 2016), http://www.thinkadvisor.com/2016/12/15/annuity-sales-to-plunge-under-dol-fiduciary-rule-c?slreturn=1491340535 (emphasis added).

[6] *Id.*

[7] COREDATA RESEARCH UK, THE FIDUCIARY RULE: SAILING THROUGH THE FIDUCIARY FOG 21 (2016).

In the three months since we filed our April 2017 comment letter, an even larger body of evidence demonstrates that access to annuities is being limited by the Fiduciary Rule.

- *Overall annuity sales* in the first quarter of 2017 (the latest quarter for which information is available) are down between 12%[8] and 18%[9] from the first quarter of 2016. This is the fourth consecutive quarter of decline in overall annuity sales.[10]

- Although sales of all types of *fixed annuities* during the first quarter of 2017 rose 8.9% from the last quarter of 2016, they declined 13.9% when compared to the first quarter of 2016.[11] *Fixed indexed annuity* sales declined 2.5% from the fourth quarter of 2016, and 10.1% from first quarter 2016 sales.[12]

- *Variable annuity* sales declined 4.6% from the last quarter of 2016 to the first quarter of 2017 and suffered a 10.2% decline from the first quarter of 2016.[13] Net flow in variable annuities fell to a record low of -$17.8 billion in the first quarter of 2017.[14]

- Analysts place responsibility for the declines in annuity sales largely on the effects of the Fiduciary Rule:
  - Todd Giesing, Assistant Research Director, LIMRA Secure Retirement Institute, explained that "[d]espite an improvement in the equities market and interest rate environment [during the first quarter of 2017], *uncertainty around the DOL rule* overwhelmed any impact it may have had on annuity sales."[15]
  - Kevin Loffredi, Senior Product Manager at Morningstar, speaking of variable annuities in particular, commented that "[t]he first quarter [of 2017] is repeating the pattern of recent quarters; small decline in sales, more dollars coming out than going in, and an increasing amount in variable annuity assets. The equity markets deserve the credit for the

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[8] LIMRA SECURE RET. INST., FIRST QUARTER 2017 U.S. RETAIL ANNUITY SALES SURVEY (2017), http://www.limra.com/Posts/PR/Data_Bank/_PDF/2017-1Q-Annuity_Estimates.aspx.

[9] News Release, Insured Ret. Inst., IRI Issues First-Quarter 2017 Annuity Sales Report (June 16, 2017), https://www.myirionline.org/docs/default-source/press-release/q1-2017-annuity-sales-final.pdf ("IRI 1st Quarter 2017").

[10] *Annuity Sales Decline for 4th Consecutive Quarter*, INSURANCE NEWS NET (May 18, 2017), https://insurancenewsnet.com/oarticle/annuity-sales-decline-4th-consecutive-quarter (quoting LIMRA's first quarter 2017 survey).

[11] IRI 1st Quarter 2017, *supra* note 9.

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] *Annuity Sales Decline for 4th Consecutive Quarter*, *supra* note 10.

increased net assets. Some of the pressures on sales are the same, interest rates and *regulatory uncertainty* and they don't show any signs of changing."[16]

- And, analysts expect the negative impact on annuities to increase if the Fiduciary Rule remains unchanged:
  - The LIMRA Secure Retirement Institute is forecasting "indexed annuity sales will drop 5-10 percent in 2017 and another 15-20 percent in 2018 *when the BICE goes into effect.*"[17]
  - Likewise, the LIMRA Secure Retirement Institute expects "overall [annuity] sales in 2017 to fall below $200 billion, about a 5-10 percent decline, which will be the lowest annuity sales have been since 2001."[18]

This reduced access to annuities has spread beyond individual contract sales, e.g., IRAs, and has now reached small employer plans. In particular, the Fiduciary Rule's gap with regard to independent insurance agents is having a material effect on retirement plan access and coverage. Independent agents typically serve small employers and fill a vital role in reaching low- and middle-income employees, but published reports indicate that many defined contribution plan providers are refusing to issue group annuity contracts when a plan is advised by an independent insurance agent.[19] In addition, first quarter 2017 sales of fixed indexed products sold through independent producers declined 9.2% when compared to the fourth quarter of 2016.[20]

In light of the above data, we want to reiterate what we said in our July 21 letter. None of the input the Department receives from the Committee in this letter, or from any other commenters, can be properly evaluated to reduce the negative effects of the Fiduciary Rule as the President has ordered, unless the Department *announces as soon as possible* a delay in the January 1, 2018, effective date. A large number of issues remain to be considered by the Department, many of which will, we expect, result in changes to the compliance rules in the Best Interest Contract Exemption ("BICE") and PTE 84-24. The RFI also asks for comments on any issues the Department did not identify. Secretary of Labor Alexander Acosta and the Department have expressed a sincere desire to seek public input, evaluate public comments, and respond with changes to the BICE and / or PTE 84-24 (or even the regulation itself) as appropriate, as well as coordinating with the Securities and Exchange Commission ("SEC") and other regulators. *In short, the first critical action is to announce a delay immediately*.

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[16] IRI 1st Quarter 2017, *supra* note 9 (emphasis added).

[17] *Annuity Sales Decline for 4th Consecutive Quarter*, *supra* note 10 (emphasis added).

[18] *Id.*

[19] *DOL fiduciary rule causing DC-plan record keepers to change business with insurance agents*, INVESTMENT NEWS (July 24, 2017), http://www.investmentnews.com/article/20170724/FREE/170729972/dol-fiduciary-rule-causing-dc-plan-record-keepers-to-change-business.

[20] IRI 1st Quarter 2017, *supra* note 9. This decline encompasses fixed indexed annuities only and includes both sales subject to the Fiduciary Rule and those not subject to the Fiduciary Rule.

We also want to reiterate that, while most of our comments in this response to the RFI relate to the key exemptions, we do not believe that the Department's review should be limited to the exemptions. As we stated in our April 2017 letter, the President's Memorandum requires the Department to rescind or revise the *entire* Fiduciary Rule. Accordingly, the Department will need to address (a) the expanded definition of "investment advice fiduciary;" (b) the exceptions to the new definition, including the new definition of financial education; (c) all of the conditions of the BICE and Principal Transactions Exemption; and (d) the changes to existing PTEs, including PTE 84-24.

II. <u>All Annuities Belong in a Single Workable Exemption</u>

The RFI asks a series of questions about PTE 84-24. First, we have always strongly supported retaining all annuities within PTE 84-24. The Department should not draw a distinction in PTE 84-24 between different kinds of annuities. Rather, we strongly recommend that, with appropriate conditions to ensure an adviser acts in the customer's best interest, PTE 84-24 should be available for all annuities and insurance products.

By drawing artificial lines between insurance products, the Department has incentivized regulatory arbitrage. This means that financial products are being developed and may be sold based not on what is best for the client but to respond to artificial distinctions in exemptions. We simply do not believe that it is appropriate for the Department to substitute its judgment over that of an adviser acting in the client's best interest. We did not support this notion when the Department drew a distinction in the reproposal between annuities that are securities and those that are not, and had we known the Department was actively considering drawing a distinction between "fixed rate" annuities and other annuities, we would have expressed our concerns with that distinction also.

The Department asks whether advice on all annuities would be facilitated if the Department provided an exemption for insurance intermediaries to serve as Financial Institutions under the BICE. As explained below, the insurance intermediary exemption the Department has proposed (the "IMO BICE") does not solve the problems the Department has created through the Fiduciary Rule. If finalized, the proposed exemption would create adverse consequences for Americans who will find the market for fixed indexed annuities severely constricted because the Department has offered an exemption for only a small number of insurance intermediaries and created a very high barrier to entry. Instead, as the RFI posits, the best way to move forward is to restore the scope of PTE 84-24, as it existed before the Fiduciary Rule, so that PTE 84-24 once again covers all types of annuities.

Specifically, the most straightforward way to address all of the Fiduciary Rule's issues identified by the President's February 3, 2017, Fiduciary Duty Rule Memorandum (the "President's Memorandum"), while avoiding any artificial distinctions among products, is to ***make permanent the rules the Department put in place during the transition period.*** Under the transition rules, all investment products sold by someone acting as an investment advice fiduciary must meet the Impartial Conduct Standards. Although there are slight variations in the Impartial Conduct Standards across the various exemptions, they generally require:

1. The adviser must act with appropriate prudence and care and in the client's sole interest (called "Best Interest" in the Fiduciary Rule);
2. The adviser may not make misleading statements; and
3. The adviser's compensation should be no more than reasonable for the services provided.

Making the transition rules permanent would balance the needs of plan participants and IRA owners against the massive regulatory burdens of the BICE and the revised PTE 84-24 and could be implemented relatively quickly. It would also prevent the Department from favoring one product over another while ensuring that anyone that provides investment advice acts in the client's best interest. It would be a workable solution that could be easily harmonized with whatever approach the SEC or state insurance regulators decide to take with regard to advice to non-retirement account investors.

Committee members have expressed concern that the Department may not agree with this recommendation, and continue to insist that, on January 1, 2018 (or some later date), all annuities other than fixed rate annuities must only be sold under the BICE. We want to emphasize that, if the Department does not expand PTE 84-24 to cover all annuities***, it must adequately address all of the issues the Department has created for variable and fixed indexed annuities***. These issues include:

- Finding a workable solution for the sale of fixed indexed annuities and other annuities that are sold through state-regulated independent agents and not under the supervision of a registered broker-dealer. The IMO BICE is not a solution to this problem.
- Removing the onerous contract requirements of the BICE.
- Eliminating the bias in the BICE against commissions by removing the "neutral factors" warranty.
- Eliminating the expensive and onerous web site disclosures included in the BICE.

III. DOL Should Not Solve the Issues With the Rule with Even More Exemptions

It appears from the RFI that the Department may be considering issuing even more exemptions in response to the President's Memorandum. For example, the Department asks about special exemptions for "clean shares," "T-shares," and "fee-based annuities." We believe this approach is misguided. The Department already attempted to plug one significant gap in the Fiduciary Rule – annuities sold by independent insurance agents – with a new exemption, and that proposal, as the Department heard from us and many others, failed to plug that gap. In fact, that proposal created significant new issues, such as a barrier to entry. (We discuss the issue of fixed indexed annuities and the IMO BICE in more detail below.) Issuing even more exemptions with different conditions will simply complicate compliance and, as noted above, could result in products being recommended based on a particular exemption, rather than based on what is in the individual's best interest.

Furthermore, an approach that addresses the negative effects of the Fiduciary Rule simply by issuing even more proposed exemptions would not be consistent with the President's direction, which is, if the Department makes an affirmative determination regarding the factors laid out in the President's Memorandum, the Department must "publish for notice and comment a proposed rule ***rescinding or revising*** the Rule, as appropriate and as consistent with law."[21] The President's direction was not to "propose new exemptions." The President instructed the Department to rescind or revise the Fiduciary Rule, including the BICE and other amendments released in connection with the regulatory changes. Had the President wanted the Department to issue more exemptions, he could have easily said so.

IV. If the BICE is Retained, DOL Should Remove or Modify the Unworkable Conditions

The RFI asks about the impact of two possible changes to the BICE. First, it asks about the impact of substantially altering or eliminating the contract requirement for IRAs. Second, it asks about the impact of substantially altering or eliminating the warranty requirements of the BICE.

Contract requirement. The BICE requires a Financial Institution to (a) agree to a new cause of action that does not exist under current law in connection with IRAs; (b) refrain from including any provision in the contract that would restrict or limit the Financial Institution's liability; and (c) refrain from requiring clients to bring class actions through arbitration. As we and others have explained previously, the contract requirement is unnecessarily burdensome, invites frivolous litigation, and should be removed. The Department, in the litigation challenging the Fiduciary Rule, has already decided not to defend the arbitration prohibitions, recognizing the prior administration went too far.

The litigation risk created by the BICE is particularly acute for Financial Institutions that distribute variable annuities.[22] Variable annuities provide a variety of guarantees, e.g., guaranteed lifetime income, guaranteed death benefits, and the option of various forms of principal and investment return guarantees. These guarantees provide benefits to policyholders, but create risks for the insurers making the guarantees, and thus have costs. We appreciate the statements from the Department indicating that the lowest cost investment is not necessarily the best, but as a practical matter, the features of the annuity market that reflect basic economic principles will be the same features that will attract frivolous class action litigation.

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[21] 82 Fed. Reg. 9,675, 9,675 (Feb. 7, 2017) (emphasis added).

[22] The proposed Best Interest Contract Exemption for Insurance Intermediaries would present the same litigation risk for independent marketing organizations ("IMOs") that distribute fixed indexed annuities because it is a clone of the BICE in this regard.

On this point, the Department's economic analysis simply misunderstands the current state of class action fiduciary litigation. The Department's analysis states the following regarding increased litigation cost:

> Commenters on the 2015 Proposal said that some insurance policies cannot be used to pay for penalties, and some do not cover litigation costs if the covered individual loses their case. The commenters cite these situations to suggest that the cost from claims is not fully captured by the increased cost of the insurance premiums. For those fiduciaries that are accused of wrong doing and successfully defend against the claim, the insurance coverage pays for the litigation. These costs should be captured in this analysis and are discussed below. The costs that are not quantified in the following analysis are penalties paid by the advisers who lose their cases.[23]

This analysis assumes that cases are simply won or lost based on their merits, and that the only costs for a firm that has not committed a breach is the litigation cost covered by insurance. It further assumes that cases end in judgements for or against defendants, and that settlements only result from wrongdoing. **This misses the entire point of litigation risk**: Because fiduciary litigation is fact-intensive, even frivolous cases can result in large settlements.[24] This phenomenon has been amply demonstrated in the explosive growth of litigation targeting 401(k) and 403(b) plans. Class action plaintiff firms will sue multiple employers on a single day with copy-cat complaints. These cases drag on for years, even though class action firms have been largely unsuccessful in winning cases at trial. They have, however, been able to extract large settlements by avoiding motions to dismiss because the cases cannot be dismissed before expensive discovery. And there is no reason to conclude the same will not occur with the BICE. As an exemption, the BICE is an affirmative defense that depends on the facts of the case and cannot be asserted on a motion to dismiss.[25] This is because the BICE contains a variety of

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[23] DEP'T OF LABOR, REGULATING ADVICE MARKETS: REGULATORY IMPACT ANALYSIS FOR FINAL RULE AND EXEMPTIONS 239 (2016).

[24] For instance, based on 2016 data, 62.5% of class actions were resolved by settlement, and 72.2% of all settlements will require affirmative claims for money. CARLTON FIELDS JORDEN BURT, THE 2017 CARLTON FIELDS CLASS ACTION SURVEY: BEST PRACTICES IN REDUCING COSTS AND MANAGING RISK IN CLASS ACTION LITIGATION 25, 27 (2017). Conversely, just 2.1% of cases go to trial. *Id.* at 25.

[25] Generally, an affirmative defense cannot be raised in a motion to dismiss. As one civil procedure treatise explains, "Numerous cases . . . state that the affirmative defenses specifically listed in Federal Rule 8(c), as well as those captured by the catchall clause . . . must be asserted in the defendant's answer." 5 FED. PRAC. & PROC. CIV. § 1277 (3d ed.). The rationale behind this rule is "based on the view that motions to dismiss or to strike cannot be used to resolve disputed fact questions . . . . Since the facts necessary to establish an affirmative defense generally must be shown by matter outside the complaint, the defense technically cannot be adjudicated on a motion under Rule 12." *Id.*

This circumstance is problematic for firms that intend to rely on the BICE because prohibited transaction exemptions are generally considered to be an affirmative defense by courts. Most recently, the Seventh Circuit held, "[A]n ERISA plaintiff need not plead the absence of exemptions to prohibited exemptions. . . . We now hold squarely that the section 408 exemptions are affirmative defenses for pleading purposes." Allen v. GreatBanc Trust Co., 835 F.3d 670, 676 (7th Cir. 2016). Five other circuits also agree that section 408 exemptions are affirmative conditions that can only be shown to have been satisfied during a trial, including that a firm's policies and procedures meet the conditions of the BICE.

Warranties. Although the Department asked about the warranty requirements, in our view, the RFI failed to focus in on the most disruptive feature of the BICE: *The BICE's compensation requirements make it nearly impossible to maintain traditional incentive-based compensation, e.g., commissions, even when that compensation structure is in the client's best interest.*

In order to satisfy the BICE, a Financial Institution must warrant not to "use or rely upon quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation or other actions or incentives that are intended or would reasonably be expected to cause Advisers to make recommendations that are not in the Best Interest of the Retirement Investor." Since the finalization of the rule, Committee members have expressed deep concern about relying on "neutral factors" to justify ordinary differences in compensation. The reason for this concern is that *any* difference in compensation among products is subject to second guessing after the fact by plaintiffs' lawyers zeroing in on the warranty in the contract.

If products sold through commission-based compensation models are not sold because of litigation fears, there will be fewer choices for savers. Furthermore, because of the litigation risk associated with the BICE, the Department will have created a strong incentive for Financial Institutions that sell annuities to have clients hold assets in a fee-based account, i.e., regulatory arbitrage. (That problem is discussed in Part VI of this letter.)

Prohibition on Liability Limits. A feature of the BICE requirements to which not enough attention has been paid is the prohibition on ***any*** provision limiting the liability of the Adviser or Financial Institution for violation of the contract's terms. It is hard to contemplate a rule that would interfere more in the ability of parties to contract freely. As these contracts are being drafted, it is becoming increasingly apparent that rather common contractual provisions, widely accepted in commerce, are in question because of the breadth of this prohibition. The preamble to the final BICE regulation notes that there were a variety of questions regarding this condition, including exhaustion of arbitration, venue selection, and liability of third parties. The Department declined to address them in the exemption, however, and stated it would provide additional guidance. No such guidance has been provided. Even if there were FAQs issued by the Department on this issue, nonbinding FAQs would not prevent private lawsuits alleging any of these common provisions violate the warranty, meaning the entire exemption is not applicable to the sale.

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defenses, or that the defendant bears the burden of proof, or both. *See* Harris v. Amgen, Inc., 788 F.3d 916, 943 (9th Cir. 2015), *rev'd on other grounds*, 136 S. Ct. 758 (2016); Braden v. Wal-Mart Stores, Inc., 588 F.3d 585, 601 n.10 (8th Cir. 2009); Elmore v. Cone Mills Corp., 23 F.3d 855, 864 (4th Cir. 1994); Lowen v. Tower Asset Mgmt., Inc., 829 F.2d 1209, 1215 (2d Cir. 1987); Donovan v. Cunningham, 716 F.2d 1455, 1467-68 (5th Cir. 1983).

V. The Department Must Address the Treatment of Fixed Indexed Annuities

As has been widely discussed, the Fiduciary Rule as issued would effectively prohibit the sale of fixed indexed annuities by IMOs to plans or IRAs. This is because of the requirement permitting only certain "Financial Institutions" to be a party to the BICE contract. The Department's response to the problem it has created appears to be two-fold. First, it continues to suggest that it is workable for an insurance company to serve as a Financial Institution. The Department's premise that insurance companies will agree to serve as Financial Institutions with respect to the sale of their products by independent insurance agents is incorrect based on what has actually happened in the marketplace. Part of the reason is that there continues to be significant concern that an insurance company may not be able to truly meet the conditions of the BICE for an annuity sold through an independent insurance agent. Independent agents, by definition, can sell the products of multiple Financial Institutions. Companies are very concerned about meeting the fiduciary level of care embodied in the "Impartial Conduct Standards" without knowing and evaluating the other products the independent insurance agent has to offer. The Department stated in an FAQ that when an insurance company acts as a Financial Institution, "its responsibility is to oversee the recommendation and sale of its products, not recommendations and transactions involving other insurers."[26] But this level of deliberate ignorance is not generally considered consistent with a fiduciary level of care. In addition, Committee members continue to question the extent to which there could be liability for sales by that agent of another company's products, particularly to the same customer. Not surprisingly, we have been unable to identify any insurance company that has publically stated its intention to serve as a Financial Institution for its products sold through independent agents.

As a second possible solution, the Department proposed the IMO BICE. The proposed IMO BICE, in its current form, will not fill the gap the Fiduciary Rule created or restore access to fixed indexed annuities. For example, the proposed IMO BICE would condition relief upon an IMO (a) having transacted sales of fixed annuity contracts averaging at least $1.5 billion in premiums per fiscal year over its prior three fiscal years, and (b) having fiduciary insurance or reserves of at least 1% of the average amount of premium sales by the IMO over the prior three fiscal years. We understand that only a small number of IMOs would meet these requirements.

Besides restricting access to products because of the limited number of IMOs that can meet the proposed IMO BICE conditions, the IMO exemption is also very disruptive because it serves as a "barrier to entry." An IMO that does not currently meet the high sales threshold of $1.5 billion in average premiums over its prior three fiscal years will be prohibited from serving as an intermediary for any IRA annuity sales. However, IRAs represent more than half of all fixed indexed annuity sales outside of institutional markets.[27] As a result, an IMO that is not currently eligible for the IMO BICE will find it extremely difficult to *ever* become eligible.

[26] Conflict of Interest FAQs (Part I – Exemptions) (Oct. 27, 2016), Q&A-22.

[27] LIMRA Secure Ret. Inst., *Presentation to Federal Advisory Committee on Insurance* (2015), https://www.treasury.gov/initiatives/fio/Documents/LIMRA8.6.15.pdf.

The solution to this problem is not to double down on these two unworkable approaches. Rather, we believe that fixed indexed annuities, and all annuities, should be covered under a single workable and balanced exemption, such as PTE 84-24 amended to add the Impartial Conduct Standards, as discussed in Part II.

VI. Fee-Based Annuities are an Emerging Product, but Not a Panacea

The RFI seeks information on "fee-based" annuities. This product is not new, but there is not a common understanding of what is meant by a "fee-based annuity." In addition, the product is undergoing change, largely because of the market disruptions caused by the Fiduciary Rule's treatment of commissions. Traditionally, however, the term "fee-based" (or "advisory annuity") has been used to refer to an annuity offered only through an "investment adviser" or an "investment adviser representative" registered under the Investment Advisers Act, who does not receive a commission from the insurer. Fee-based annuities often are variable annuities, but fixed indexed annuities also can be fee-based. The adviser is typically paid a fee equal to a percentage of the assets under management for the client, including the annuity. In the case of an annuity, the fee may be charged against the value of the contract or paid from other assets under management.

The costs and the benefits of fee-based annuities may differ from a commission-based annuity. For example, a fee-based annuity may not have surrender charges, or may have surrender charges that are a lower percentage or shorter duration than those of a commission-based annuity. Other charges, e.g., mortality and expense risk charges, may also differ between fee-based and commission-based annuity contracts. Benefits also may differ between the two types of annuities. For example, some investment advisers may discourage clients from purchasing certain types of optional benefits, e.g., a return of premium death benefit, because the adviser believes the risk against which the benefit provides protection can best be addressed in a different manner, e.g., a less volatile portfolio. Both the amount of fees and the amount of the benefits can also be affected by the insurer's assessment of potential behavioral differences between clients who purchase a fee-based annuity and those who purchase a commission-based annuity, e.g., which are more likely to hold their annuity for a longer time.

The Department should understand that there are many questions outside of the Department's jurisdiction regarding fee-based annuities. For example, the Internal Revenue Service ("IRS") has not taken a consistent position regarding the tax consequences of payments from fee-based annuities to an adviser. Historically, the IRS has viewed a withdrawal from an annuity held as an individual retirement annuity or under an IRA account, or held under a qualified plan, as a non-taxable payment of expenses of the IRA or plan. The IRS's reasoning has been that these payments are similar to payments from a qualified trust for ordinary investment expenses of the trust. But this guidance has come in the form of private letter rulings only, which cannot be relied upon or cited as precedent.[28]

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[28] *See, e.g.*, PLR 9845003 (Aug. 3, 1998); PLR 9332040 (May 18, 1993); PLR 9047073 (Aug. 30, 1990); PLR 9005010 (Nov. 2, 1989); and PLR 8951010 (Sept. 18, 1989).

The IRS has taken a different position, however, regarding the tax consequences of a fee associated with non-qualified annuities. The IRS has ruled that the fee paid in connection with a non-qualified fee-based annuity would be a distribution from the contract.[29] This different treatment can affect whether the fee is paid from the annuity's account value or from other client assets managed by the adviser.

Further, it appears that the Department may be contemplating that fee-based annuities will grow as a *substitute* for the payment of a commission in connection with the sale of the product. The IRS has not ruled on the treatment of a fee-based annuity where the "fee" is a substitute for a front end or trailing commission, and the position the IRS would take is very uncertain.

There are other regulatory questions regarding fee-based annuities. For example, we understand that the New York Department of Financial Services has raised issues regarding whether a producer should be allowed to offer both a commission-based product and a fee-based product due to the potential for conflicts of interest. We also understand that the process for approval in some states for fee-based annuities is slow, and, because these products are relatively new to regulators, can require significant back and forth. Finally, the SEC has made it an enforcement priority to prevent clients from being placed in an advisory account (where a fee-based annuity would typically be used) when the client does not need and is not being provided ongoing services, a practice described by the SEC as "reverse churning."[30]

Once states do approve fee-based annuities, broker-dealer platforms are not designed to easily accommodate them. It will take significant time for the platforms to accommodate them, and to educate brokers and advisers on when and how to use them with clients. And this is not the first priority for broker-dealer firms who are scrambling to comply with the Fiduciary Rule for products already on their platform.

While fee-based annuities can be an appropriate solution in many circumstances, they are not a panacea for the myriad of disruptions caused by the Fiduciary Rule. Generally, a fee-based annuity is appropriate only when there is a need for ongoing investment advice services and thus may not be a solution for independent insurance agents who are not registered investment advisers. Some owners need and desire ongoing advice in connection with an annuity; others do not. This depends, in part, on the sophistication of the owner and the nature and features of the annuity contract. For individuals who do not need or wish to pay for ongoing advice, a commission paid in connection with the services (including the recommendation to purchase the product) provided at the time of sale is sufficient and appropriate. As we have said many times, the preference in the Fiduciary Rule for compensating brokers and agents using an asset-based or other permanent flat fee will result in many individuals paying more over time for services that they do not need or want. The problem is that the Department's rule, including the BICE,

[29] *See* PLR 9342053 (July 28, 1993).

[30] Press Release, SEC, SEC Announces 2016 Examination Priorities (Jan. 11, 2016), https://www.sec.gov/news/pressrelease/2016-4.html.

disadvantages commission-based products, even when a one-time, transactional commission is the appropriate compensation for the services provided by the agent or broker.

The Department asks if "all the compensation would come from the consumer or would there also be payments from the insurance company?" A fee-based annuity traditionally has not provided a commission since, as described above, the product has generally been available only through fee for service advisers. This may be changing with the development of newer designs. Nevertheless, this question reflects a misunderstanding of the economics involved. An agent, adviser, or broker must be compensated for the services provided, and this compensation must be no more than a reasonable amount. Whether the payment "comes from" the consumer or "comes from" the insurance company, dollars are fungible and the cost of the services is reducing the ultimate benefit that can be provided under the contract. A fee-based annuity is not fundamentally better than a commission-based annuity – an annuity's value depends on the customer's needs and desires. In any event, the solution to the disruptions caused by the Fiduciary Rule and the BICE should not advantage one product or one source of compensation for brokers, over another.

The point of the foregoing discussion is not that fee-based annuities do not have a valuable role to play for many consumers, but rather that they are not a panacea to the issues created by the Fiduciary Rule for Americans losing access to guaranteed income products.

The Department also asks if it should propose yet another exemption for fee-based annuities. We do not support that approach. We continue to believe that all annuities should be sold under a single exemption that is built around the Impartial Conduct Standards and disclosure of the compensation to be paid to the broker, agent, or adviser, as discussed in Part II above. In any event, we fail to see why a special exemption for fee-based annuities is needed. If the adviser is paid in a way that is not a prohibited transaction at all (because the adviser's advice cannot affect his or her compensation) then there is no need for an exemption (except in the case of a rollover recommendation, which is already addressed by Section II(h)(3) of the BICE).

VII. Effect of Fiduciary Regulation on Terminal Funding Contracts

In our 2015 comment letter on the Department's reproposal, we expressed significant concerns regarding the effect of the rule on the sale of annuities in connection with terminating defined benefit plans, particularly small plans. We pointed out that the Department's economic analysis in connection with the reproposal did not consider the effect of the proposal on these annuities (typically called "terminal funding contracts"). This failure was not cured in the final rule or addressed in the regulatory impact analysis. In fact, we searched the regulatory impact analysis for the terms "defined benefit plan" and plan "termination" and found no instances of those words. *As best we can tell, the Department simply did not analyze the costs and benefits of the Fiduciary Rule on terminating defined benefit plans, particularly smaller plans, before finalizing the Fiduciary Rule,* despite this being raised during the comment period.

Congress requires defined benefit plans (including small plans) to purchase irrevocable commitments from an insurance company to provide all plan benefits following termination.[31] The Department's longstanding position on this issue provides that the selection of an annuity issuer is a fiduciary decision.[32] The Department also requires that a fiduciary must "conduct an objective, thorough and analytical search for the purpose of identifying and selecting providers."[33]

Thus, a fiduciary of a terminating defined benefit plan must seek out insurance companies that can provide the plan an appropriate annuity. Under the Fiduciary Rule, however, nearly any *recommendation* to purchase the annuity – such as the act of an insurer responding to a request for proposal ("RFP") by a plan – could be interpreted as triggering fiduciary status.[34]

We also pointed out that it is no answer to this problem that an exemption – whether the BICE or PTE 84-24 – might be available. Issuers of terminal funding contracts, which are sold through a different channel than retail annuities, will not take on fiduciary status. The final regulation addressed this issue to some extent by offering the "independent fiduciary exception" ("IFE") for larger plans (those over $50 million), but there is effectively no way to sell terminal funding contracts to smaller plans without significant risk of fiduciary status.

We pointed out in our 2015 comments that, as a result of the Department's proposed rule, plan fiduciaries would not be able to access terminal funding contracts and the market could dry up for a product that Congress requires to be used. This worry has, unfortunately, proven to be justified.

Some Committee members report that they have stopped selling terminal funding contracts to any plan of less than $50 million in assets because the IFE does not apply. As we predicted, for these members, the availability of PTE 84-24 as an exemption from the prohibited transaction rules does not resolve the issue. This is because providing fiduciary advice in the sales process with ERISA plans comes with many other obligations and conditions besides the need for a prohibited transaction exemption.

One large annuity issuer provided us the following data to illustrate how devastating this development is to small plans. In the past five years, this company's various state-licensed insurance companies have together issued terminal funding contracts with aggregate premiums of as much as $1 billion per year. In most years, more than half of their terminal funding transactions have been for plans with less than $50 million in assets. (In many cases, before the Fiduciary Rule, the number of life insurance companies bidding on the contract was very small; sometimes this issuer was the only company bidding.)

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[31] ERISA § 4041(b)(3)(A)(i).

[32] DOL Reg. § 2509.95-1(b).

[33] DOL Reg. § 2509.95-1(c).

[34] The one mention of RFPs in the final Fiduciary Rule is in connection with a platform of defined contribution investments.

If an insurer of this size exits the market, smaller plans will face a market with less competition and higher costs. In many cases, issuers will have no interest in the business because of the low margins and high litigation risks. Furthermore, since the effect of the rule is to drive up the cost of plan termination, this has significant implications for the Pension Benefit Guaranty Corporation's pension insurance program, which is already underfunded.

This problem illustrates two significant issues with the Fiduciary Rule that should be addressed: First, the rule sets such a low bar for a covered "recommendation" that sales activity, even for a product that the law requires a plan to buy in connection with a plan termination, could almost always be considered fiduciary advice. Second, the IFE should be available for *any* ERISA fiduciary. The adverse consequences discussed above can be easily avoided. Under the 2010 proposal, the Department included a sensible carve-out for situations in which the recipient of the advice knows or, under the circumstances, reasonably should know, that the person is providing the advice or making the recommendation in the person's capacity as a seller of a security or other property, who has a financial interest in the transaction, and that the person is not undertaking to provide impartial investment advice. Any fiduciary of a small defined benefit plan should be able to understand, after disclosure, that the insurance company is not undertaking to provide impartial investment advice.

In fact, there is a good case to be made that the process by which an insurance company markets and sells its terminal funding annuities will never constitute investment advice. There is no question that the plan must purchase the product – the law requires it for a terminal funding contract. And the insurance company is selling only its own contract. We fail to see how that could ever constitute "advice" to take one course of action over another.

The effect of conflating sales and impartial advice is to increase price and take away choice. Under the final Fiduciary Rule, large plan fiduciaries, because of the carve-out for "independent fiduciaries," can decide what services they will receive from financial professionals, and what advice they will pay for. Smaller plans have no choice but to buy outside advice.

If the Department is unwilling to expand the IFE to all ERISA plan fiduciaries, then it should at least expand the IFE to cover all defined benefit plans (or, at a minimum set a lower bar for independent fiduciary status for defined benefit plan fiduciaries, such as that the plan has at least 100 covered lives subject to the annuity). The policy rationale for making this change is that any fiduciary that is in charge of processing a defined benefit plan termination should be sophisticated enough to understand that insurance companies responding to RFPs are not providing impartial investment advice.

On the topic of the IFE, Committee members' experience with the exception is that the various written representations that are being required of fiduciaries are proving unnecessarily burdensome. While we appreciate the intention behind the various requirements of the IFE, companies are discovering that the representations made by the fiduciary are not working as intended. For example, one requirement of the IFE is that the "independent fiduciary of the plan or IRA is a fiduciary under ERISA or the Code, or both, with respect to the transaction and is responsible for exercising independent judgment in evaluating the transaction." This is a confusing representation to obtain, because either it is true, or the Fiduciary Rule is not triggered because no recommendation is made to a fiduciary that has authority to act. In fact, it appears that the IFE representations that are extracted from the independent fiduciary are rapidly becoming like the Treasury Department's Circular 230 disclosures on every lawyer's email – repeated to the point of being ignored. Accordingly, we urge the Department to reevaluate what requirements of the IFE really provide value to the fiduciary and which do not.

VIII. Other Issues Regarding PTE 84-24

As Committee members have evaluated PTE 84-24, a number of other compliance issues have surfaced, which we ask the Department to consider in its next rulemaking.

Coverage of all compensation. PTE 84-24 has traditionally covered commissions, which the Department has never defined. The industry has largely interpreted "commissions" to mean any compensation paid in connection with the sale of annuities. The revised PTE 84-24 limited its coverage to narrowly defined "Insurance Commissions," plus related "employee benefits," which were not defined. This has resulted in significant uncertainty. In our view, PTE 84-24 should provide relief for a range of compensation types, e.g., asset-based fees (like 12b-1 fees) paid in connection with annuities that are securities, employee benefits, non-cash compensation, and year-end bonuses. Of course, whatever compensation will be paid in connection with the sale of the annuity should be required to be disclosed.

Annual disclosure. The revised PTE 84-24 essentially requires an annual disclosure if the contract allows for additional premium payments, even if none of the information on the original disclosure has changed.[35] This is an onerous requirement that is unnecessary and costly, to no reasonable end. Eliminating this annual disclosure would meet the President's goal of removing costly regulatory requirements. (The prior version of PTE 84-24 imposed this requirement only every three years.)

Determining reasonable compensation. As the Department knows, insurance companies can compensate brokers and agents in a variety of ways. In some cases, the commission is straightforward, and determining reasonable compensation is likewise relatively straightforward. But for other types of compensation and assistance, this determination is not easy. For example, if an agent receives support to set up an office, or receives a loan for business purposes, the reasonable compensation analysis is hard to perform with any certainty. The reasonable compensation issue is not only an issue for PTE 84-24, but also for the BICE because it requires reasonable compensation "all the way up the chain" – every single payment of any kind to anybody has to be evaluated. In our view, the key is that the commission paid to someone acting as a fiduciary in connection with the sale of the product should be reasonable. This is a workable and administrable standard.

[35] PTE 84-24, Section IV(d)(1).

*   *   *

Our July 21, 2015, comment letter on the reproposal provided significant background on the important role that annuities play in a secure retirement, and explained the unique features of different kinds of annuities. Since it has been two years since the reproposal was released, we believe it would be of benefit to the Department – particularly the new leadership – to update the Appendix we attached in 2015. Given that the 29 member companies of the Committee represent more than 80% of the annuity business in the United States, the Committee obviously understands and values the importance of lifetime income to American workers and retirees. As we explain in the attached Appendix B, annuities are insurance products that are unique in their ability to guarantee lifetime income to individuals whose retirement savings have accumulated in individual account retirement plans and / or IRAs. The Department's Fiduciary Rule has and will continue to block access to annuities and guaranteed lifetime income unless the Department addresses the issues described in this letter.

If you have any questions, or if we can be of any assistance in your consideration of the issues summarized above, please do not hesitate to contact either of the undersigned at 202-347-2230.

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Attachments

- Appendix A: Members of the Committee of Annuity Insurers
- Appendix B: Background on Annuities and Annuity Insurers

THE Committee OF Annuity Insurers
www.annuity-insurers.org

Appendix A

AIG Life & Retirement, Los Angeles, CA
Allianz Life Insurance Company, Minneapolis, MN
Allstate Financial, Northbrook, IL
Ameriprise Financial, Minneapolis, MN
Athene USA, Des Moines, IA
AXA Equitable Life Insurance Company, New York, NY
Fidelity Investments Life Insurance Company, Boston, MA
Genworth Financial, Richmond, VA
Global Atlantic Life and Annuity Companies, Southborough, MA
Great American Life Insurance Co., Cincinnati, OH
Guardian Insurance & Annuity Co., Inc., New York, NY
Jackson National Life Insurance Company, Lansing, MI
John Hancock Life Insurance Company, Boston, MA
Lincoln Financial Group, Fort Wayne, IN
Massachusetts Mutual Life Insurance Company, Springfield, MA
Metropolitan Life Insurance Company, New York, NY
National Life Group, Dallas, TX
Nationwide Life Insurance Companies, Columbus, OH
New York Life Insurance Company, New York, NY
Northwestern Mutual Life Insurance Company, Milwaukee, WI
Ohio National Financial Services, Cincinnati, OH
Pacific Life Insurance Company, Newport Beach, CA
Protective Life Insurance Company, Birmingham, AL
Prudential Insurance Company of America, Newark, NJ
Symetra Financial, Bellevue, WA
The Transamerica companies, Cedar Rapids, IA
TIAA, New York, NY
USAA Life Insurance Company, San Antonio, TX
Voya Financial, Inc., Atlanta, GA

The Committee of Annuity Insurers was formed in 1981 to participate in the development of federal policies with respect to annuities. The member companies of the Committee represent more than 80% of the annuity business in the United States.

<u>APPENDIX B</u>

BACKGROUND ON ANNUITIES AND ANNUITY INSURERS

Annuities are vital to the retirement security of millions of Americans. Other than Social Security and defined benefit plans, annuities are the only means that Americans have to *guarantee* they will not outlive their retirement income.[1] With the decline in the number of employers offering defined benefit plans and the continuing strain that an aging population places on Social Security, it will be even more important to ensure that Americans have ready access to annuities in the decades to come.

Annuities provide insurance protection against longevity risk by pooling that risk among a large group of individuals. These insurance contracts also pool and protect against other significant risks to which individuals are exposed in retirement, including inflation risk, investment risk, interest rate risk, mortality risk, and liquidity risk. For any individual, these risks can persist for 30 years or more after retirement. Annuity insurers take on these substantial and long-duration risks so that individuals do not have to bear them alone.

Because annuity insurers make long-term commitments to their policyholders to shield them from numerous forms of risk, they are subject to stringent regulation by the states. The state regulatory structure is directed squarely at policyholder protection, including requiring insurers to maintain significant reserves to back the prolonged and financially-critical benefit promises they make. This paper provides an overview of the types of annuity products, the guaranteed benefits annuities provide, the types and purposes of fees an insurer charges for an annuity, and the regulatory regimes applicable to annuity insurers.

I. <u>TYPES OF ANNUITY PRODUCTS</u>

Annuities come in a wide variety of forms to meet varying consumer needs. The earliest annuities date back to ancient Rome, where contracts known as *annua* "promised an individual a stream of payments for a fixed term, or possibly for life, in return for an up-front payment."[2] Annuities represented only a small part of the U.S. insurance market until the 1930s, when Depression-era economic concerns drove investors to annuities and the financial stability insurance companies offered. This spurred the growth of flexible premium deferred annuities, which facilitate both savings accumulation and retirement income. The group annuity market also developed during this time, as corporate pension plans proliferated in the decades following World War II.[3] Since then, annuity insurers have continued to produce numerous innovations in annuity products to meet the changing needs and demands of a diverse and aging population. These include consumer demands for greater protection against inflation risk, investment risk,

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[1] *See generally*, J. BROWN, O. MITCHELL, J. POTERBA, AND M. WARSHAWSKY, THE ROLE OF ANNUITY MARKETS IN FINANCING RETIREMENT (MIT Press, 2001).

[2] James M. Poterba, *The History of Annuities in the United States*, at 7 (National Bureau of Economic Research 1997) (available on the Committee of Annuity Insurers' website at http://www.annuity-insurers.org/wp-content/uploads/2013/09/The-History-of-Annuities-in-the-United-States.pdf).

[3] *Id.* at 15-16.

and liquidity risk. The remainder of this section provides a general overview of the types of annuities available to consumers today and the various risks they help retirees manage.

A. The Basic Forms of Annuity Contracts

All annuities share the basic feature of allowing the individual to convert a lump sum into a stream of periodic payments that are guaranteed to continue for one or more lives or another specified duration. An *immediate annuity* offers only this "payout" feature, thereby facilitating the conversion to income of retirement savings the individual accumulates outside of the annuity contract. An immediate annuity is often purchased with a single premium, and the periodic payments commence within a short time (typically a year or less) after the premium is paid. There is no "accumulation phase" where the premium is credited with interest or earnings prior to periodic payments commencing.

In contrast, a *deferred annuity* offers both a payout feature and an accumulation feature. A deferred annuity can be purchased with a single premium or multiple premiums, and the periodic payments are scheduled to commence at a specified future date, often referred to as the "annuity date" or the "annuity starting date." The specified annuity date is usually many years after the contract is issued but the owner almost always possesses the right to begin annuity payments before the scheduled annuity date. Before the periodic payments commence, a deferred annuity typically provides an "account value" that the individual can access through withdrawals. The account value is credited with interest or earnings depending on the type of contract:

- *A deferred fixed annuity* provides an account value that is credited with interest at a guaranteed minimum rate. Additional interest may be credited based on the interest rate environment. Because principal and a minimum return are guaranteed, deferred fixed annuities are appropriate for individuals with lower tolerances for market volatility.

- *A deferred variable annuity* provides an account value that typically is invested in mutual funds or other securities and reflects the investment gains and losses on those assets. This provides access to equity-based returns, which present market risk, but which provide the opportunity to accumulate more retirement savings over the long term. Many deferred variable annuities also offer a fixed account option that functions in the same way as a deferred fixed annuity, thereby providing an additional option for the owner as his or her tolerance for investment risk changes over time.

- *A deferred fixed indexed annuity* provides an account value in which principal is guaranteed, interest may be credited at a guaranteed minimum rate, and interest is credited based on the positive performance of a market index, such as the S&P 500. This provides assurances against market losses but also access to equity-like returns.

- *A deferred registered indexed annuity* provides an account value that will reflect the performance of a market index, such as the S&P 500, but where neither the principal nor a minimum interest rate is guaranteed. However, losses are generally buffered or subject to a floor or participation rate, limiting the owner's exposure to market losses while providing access to equity-like returns.

The foregoing basic types of annuity contracts provide traditional payout or "annuitization" options that the individual can elect based on his or her personal needs and goals. The most widely available forms of annuitization options are summarized next.

B. Basic Annuity Payment Options

1. Life-Contingent Payments

From a retirement security perspective, the most important annuity payment option available under an annuity contract is the life-contingent payout option, although other payout options may be better suited to an individual's particular needs. Under a *traditional fixed life-contingent annuity*, the life insurance company guarantees that the individual will receive regularly-scheduled periodic payments for as long as the individual lives. The payments can be guaranteed for a single life or for two lives. These payments can be obtained from an immediate annuity, where the contract is purchased with a single premium and the periodic payments commence shortly thereafter. Life-contingent annuity payments also can be obtained from a deferred annuity that has transitioned from its accumulation phase to its payout phase.

In that regard, all individual deferred annuity contracts include guaranteed "annuity purchase rates." This is an insurance guarantee that each dollar of account value applied to a payment option will produce at least a specified dollar amount of periodic income payment for life varying with the age at which the payment option is elected. (The older the individual, the higher the income payment per dollar applied.) Typically, when the deferred annuity owner is ready to apply the account value to a payment option, the resulting payments will be calculated at the greater of the contract's guaranteed annuity purchase rates or the purchase rates the insurance company is currently offering.[4]

Life-contingent annuity payments are sometimes compared to "life expectancy" distributions generated through the systematic sale or redemption of mutual fund shares from an individual account, such as a custodial or brokerage account. Such distributions, whether taken over life expectancy or in some other form attempting to mimic an annuity, cannot provide the same guarantees and benefits to retirees as a lifetime annuity. As a result, they cannot achieve the goal of assuring retirees an adequate income that will continue throughout their entire life:

- Periodic payments over life expectancy generated through sales or redemptions of mutual fund shares from an account, such as an IRA, provide less retirement income than a lifetime annuity purchased with an equal sum and earning an equal return. Moreover, for those individuals who live long lives, such periodic withdrawals from an account will result in dramatically decreasing income payments in the later years of life when income is needed the most, whereas lifetime annuity payments will not decrease.

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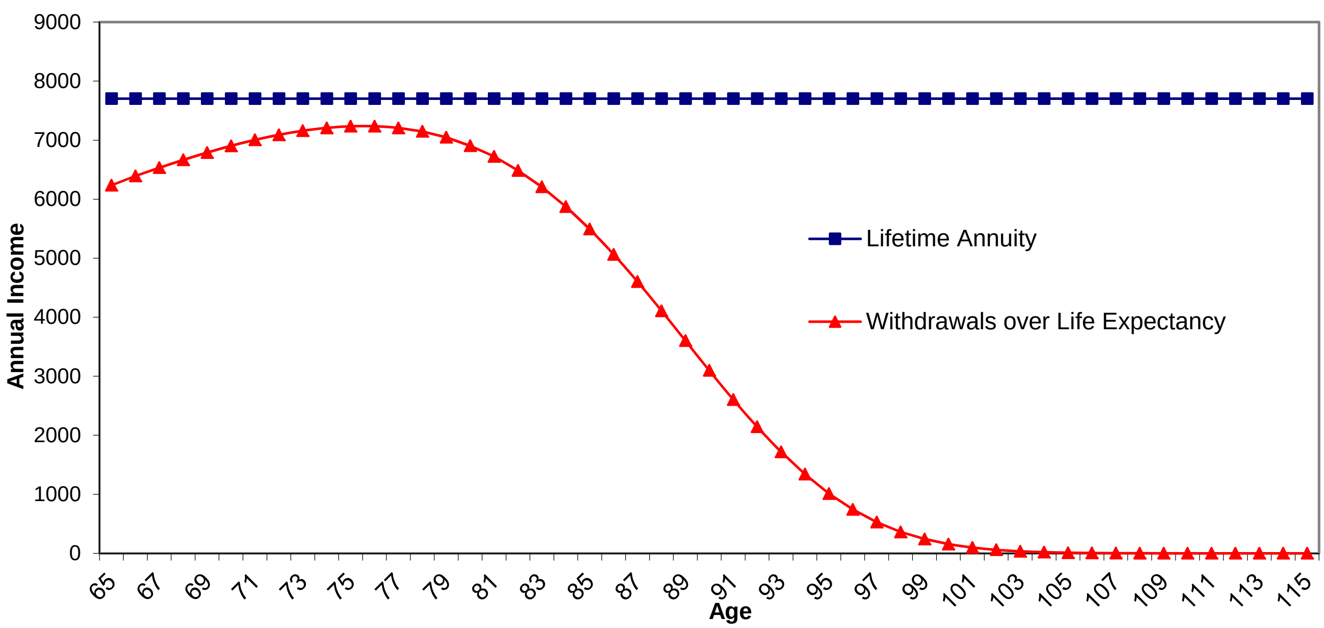
[4] Guaranteed annuity purchase rates may have significant future value. If medical advances result in a material increase in longevity, that increase in longevity would reduce the annuity purchase rates *currently* offered by an insurance company (*i.e.*, each dollar applied to a life-contingent payment option would produce a lower dollar amount of periodic income for life). However, that increase in longevity cannot reduce annuity purchase rates locked in at the time a deferred annuity contract is issued.

- Lifetime annuities can pay this extra income because life insurance companies pool the premiums and longevity risks of many individuals. This also is true for lifetime annuities that include a refund feature, *e.g.*, one that makes payments for the longer of the annuitant's life or 15 years.[5]

The following illustration compares the income from a lifetime annuity stream with the income from life-expectancy distributions from an account holding mutual funds, when both are generated from the same initial investment. As shown in the illustration, the risk pooling benefit of a lifetime annuity provides superior income security throughout retirement:

Comparison of Lifetime Annuity Income and Periodic Sales of Mutual Fund Shares over Life Expectancy



Source: Jeffrey R. Brown, *The New Retirement Challenge* (September 2004). All calculations are based on a $100,000 initial investment. Investment returns under the annuity and account are both set equal to 4.58% (which was the yield on 10-year government securities in April 2004). Mortality rates and life expectancies are those for a 65 year-old man, based on the 1939 birth cohort life table from the 2004 Social Security Trustee's Report. Withdrawals from the account are assumed to occur at the end of each year, after interest has been credited.

Other forms of life-contingent annuity income are available in addition to the traditional fixed life annuity payout illustrated above. For example, *variable life-contingent annuities* protect against longevity risk as well as inflation risk by providing lifelong income and access to equity returns. In addition, life annuity payouts are available under *longevity insurance* ("deferred income" annuity) products, which provide individuals an affordable way to protect against the risk of running out of income from their other retirement assets if they outlive their life expectancy. In general, a longevity insurance contract is an annuity that provides no cash value, provides a very limited death benefit (if any), and pays a stream of periodic payments for the individual's life (or the joint lives of the individual and a beneficiary) commencing late in life. As the Treasury Department has recognized, "purchasing longevity annuity contracts could

[5] Of course, a life annuity with a refund feature will provide lower payments than a life annuity with no refund feature because of the actuarial cost of the refund feature.

help participants hedge the risk of drawing down their benefits too quickly and thereby outliving their retirement savings."[6]

2. Period Certain Annuity Payments

Annuity contracts also typically offer annuity payees options that guarantee periodic payments will continue for a specified period, such as 10 or 20 years. These options may be elected as an independent benefit or in combination with a life annuity payout. For example, an annuitization option can provide for payments that will continue for the longer of an individual's life or 10 years. If the individual lives for more than 10 years after payments have commenced, the payments will continue for the rest of his or her life. But if the individual dies before the 10-year period has expired, his or her heirs will receive the remaining payments, either in a lump sum or as continued installments. This provides the individual with comfort that an untimely death will not result in a "loss" of the annuity premium. Indeed, such assurances are critical to most annuity purchasers, because as discussed next many retirees are hesitant to purchase a life annuity.

C. Annuity Industry Innovations to Meet Modern Consumer Demands

Despite the substantial benefits of life annuitizations, individuals are often hesitant to choose that form of payout from their annuity contracts. Scholars have speculated that one reason for this could be a behavioral response to the risk-pooling nature of insurance – an individual's fear of financially "losing" if early death prevents the payment of at least a significant amount of cash benefits under the contract.[7] Another potential reason is the perceived loss of "control" over one's savings, because converting a lump sum into a series of life annuity payments often involves a corresponding reduction in liquidity with respect to the annuitized sum.[8] These responses may be economically irrational in light of the purpose and nature of life annuities, but they nonetheless contribute to the relative infrequency of life annuitization.

In response, annuity insurers have developed innovative products in the modern era that help address many of these perceived barriers to electing life-contingent forms of payout. Industry innovations also have addressed growing consumer demand for insurance protections against interest rate risk and investment risk. These types of advances in annuity product design are sometimes called "*living benefits*," because they provide financial and insurance guarantees

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[6] Longevity Annuity Contracts, 77 Fed. Reg. 5443, 5445 (proposed Feb. 3, 2012) (proposing regulations under Code section 401(a)(9) to facilitate the use of "qualifying longevity annuity contracts" in defined contribution plans and IRAs). The regulations have since been finalized. *See* 79 Fed. Reg. 37,633 (July 2, 2014).

[7] *See, e.g.*, Jeffrey R. Brown, *Rational and Behavioral Perspectives on the Role of Annuities in Retirement Planning* (Nat'l Bureau of Econ. Research, Working Paper No. 13537 October 2007), *available at* http://www.nber.org/papers/w13537 (discussing (1) complexity and financial literacy, (2) "mental accounting" and "loss aversion," (3) "regret aversion," and (4) the "illusion of control" as behavioral factors that may contribute to a reluctance to annuitize); Wei-Yin Hu and Jason S. Scott, *Behavioral Obstacles to the Annuity Market* (Soc. Sci. Research Network, Working Paper March 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=978246 (similar).

[8] *See id*.

throughout the individual's life. The general types of living benefits can be categorized as accumulation benefits and distribution or payout benefits, as discussed below.

1. Accumulation Benefits

Many annuity products offered today include features that allow individuals to benefit from increases in the equity markets while limiting (either partially or completely) their downside risk to market losses. For example, *deferred fixed indexed annuities* provide a principal guarantee coupled with interest credits that are linked to an equity market index, such as the S&P 500. Likewise, many *deferred variable annuities* offer optional benefits that can protect against market risk while still providing access to equity markets. For example, *guaranteed minimum accumulation benefits* or *GMABs* guarantee a minimum rate of return before annuity payments commence, regardless of the performance of the mutual funds held under the variable annuity. *Deferred registered index annuities* provide exposure to an equity market index, such as the S&P 500, but include a buffer or floor. These and similar features encourage individuals to invest in assets that are more likely to provide higher returns, while reducing or eliminating the risk of investment losses. Such features contribute greatly to the overall retirement security of many annuity owners.

2. Distribution Benefits

Other important innovations in annuity product design focus on the decumulation or payout of accumulated savings. These include *guaranteed minimum income benefits* and *guaranteed withdrawal benefits*. Each of these provides protection against market risk and longevity risk.

a. Guaranteed Minimum Income Benefits

A guaranteed minimum income benefit or "GMIB" is designed to provide the annuity owner with a base amount of lifetime income when he or she retires regardless of how the account value within the contract has performed. This feature can be included within a fixed annuity or a variable annuity. The typical GMIB provides that if the individual annuitizes the contract on a life-contingent basis (with or without a period certain), the resulting annuity payments will be calculated using the greater of the contract's account value or a "benefit base." The benefit base is typically calculated by reference to the cumulative premiums paid plus notional interest calculated at a specified rate, such as 1-4%. Thus, the value applied to a life annuity option can exceed the value available if the contract is surrendered for a cash lump sum.

b. Guaranteed Withdrawal Benefits

Another important innovation in annuity product design is the *guaranteed withdrawal benefit*. These benefits, which are commonly available with fixed indexed and variable annuities, provide that each year during a specified duration a guaranteed minimum amount will be available to withdraw from the annuity's account value, irrespective of the actual balance in the account at that time. The guarantee can be scheduled to last for a specified period (such as 10 years) or for the entire life of one or two individuals. The former iteration of the benefit is typically called a *guaranteed minimum withdrawal benefit* or *GMWB*, while the latter is typically called a *guaranteed lifetime withdrawal benefit* or *GLWB*. In either design, the guaranteed minimum withdrawal amount is normally determined as a percentage of a specified "benefit base." The percentages differ by product and insurer, but for GMWBs they typically range from 4-6% and for GLWBs they typically depend on the individual's age and range from 3-5%, with some percentages as high as 7% if the individual waits until a later age (such as 70) before taking the first withdrawal.[9]

The benefit base is initially equal to the amount invested and is subject to adjustments thereafter. It is typically adjusted to equal the account value on the date of the first withdrawal. Other adjustments can include a "step-up," where the benefit base is re-set periodically to equal the higher of the current account value or the account value on a specified prior date, such as the previous contract anniversary. Another type of adjustment is a "roll-up," where the benefit base is re-set periodically to equal the higher of the current account balance or the cumulative premiums plus notional interest determined at a specified rate. Other benefit base adjustment features may be available. These additional features such as step-up and roll-up adjustments provide added protection against market loss, and in many cases they are offered as options that can be included with a basic GLWB for an additional cost.

In providing these types of guaranteed withdrawal benefits, the annuity insurer takes on significant and long-term risk including investment risk and, in the case of a GLWB, additional longevity risk. As a result, the insurer must take steps to hedge these risks. For example, the insurer must carefully select and manage complex derivatives and other investments that will provide economic protection against volatility and loss in the financial markets. This requires a significant outlay of capital on the insurer's part. To reduce the cost of such hedging activity and otherwise reduce risk, the issuer of a variable annuity also will typically impose restrictions on how the individual may allocate his or her account value among the available investment options under the contract. For example, the insurer may require that the individual's investment allocations produce a relatively balanced portfolio of equity and fixed income investments in order to reduce the chance of excessive volatility in the account value.

For the consumer, GMWBs and GLWBs facilitate equity returns while providing protection against investment risk and longevity risk. Equally important, they protect against these risks while preserving the liquidity of the individual's account balance. In other words, the individual is protected against longevity risk without having to relinquish "control" over his or her savings. This greatly reduces the psychological barrier to electing a form of payout that protects the individual against outliving his or her assets in retirement. Of course, if the individual exercises his or her liquidity rights by withdrawing more than the guaranteed amount in any given year, the guaranteed amount is reduced proportionately for subsequent years. Nonetheless, the individual remains in control of his or her own savings, which is a key motivation of today's retirees. A well-respected textbook on insurance summarizes all this as follows:

> [T]he annuity industry is largely driven by buyers who elect investment guarantee options that prevent significant losses while retaining the opportunity for modest investment gains. These

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[9] INSURED RETIREMENT INSTITUTE, IRI FACT BOOK, at 65-66 (2016).

> include guarantees as to minimum withdrawal, income, and/or accumulation and as to life-time withdrawals. Equity-indexed and inflation-indexed annuities also provide guarantees.
>
> Of course, guarantee options are not free. Insurers charge for them, thereby, reducing benefits. Savers may find guarantees more attractive than pure annuities, because they are perceived to be less as a gamble, reduce the possibility of regret, and/or maintain increased liquidity.[10]

D. Death Benefits

Virtually all deferred annuities provide death benefits, and it is very common for those benefits to guarantee a return at least equal to the contributions made to the contract.[11] This is often called a return of premium or "ROP" death benefit. Optional "enhanced" death benefits also are available to provide additional protection against the convergence of market loss and untimely death. Enhanced death benefits include "ratchet" or "high water mark" designs, where the minimum death benefit equals the greatest of the ROP death benefit, the contract's account value on the date of death, or the highest account value on a specified previous date, such as the prior contract anniversary. Other enhanced death benefit designs include "roll-ups," where the minimum death benefit equals the higher of the date-of-death account balance or the cumulative premiums paid plus interest at a specified notional rate.

These types of benefits indirectly facilitate a more financially secure retirement for annuity owners because they allow owners to invest in equity markets without fear of leaving dependents and other beneficiaries with inadequate assets should the owner die unexpectedly during a downturn in the financial markets. Nevertheless, a bequest motivation may not be the reason an ROP or enhanced benefit is desired; rather, it may be the more fundamental behavioral response described above – fear of having made a bad financial decision if early death prevents the payment of at least a significant amount under the contract.

II. ANNUITY PRODUCT PRICING: FEES AND CHARGES

A. In General

Annuities provide a variety of guarantees that are critical to individuals assuring themselves a secure retirement. The guarantees often cover multiple risks and persist for long durations, such as 30 years or more for any given policyholder.

The specifics of these risks, the guarantees made by insurers with respect to these risks, and fees for these risks, are described in this section. We respectfully submit that when these risks and guarantees are properly understood, it is entirely appropriate that the "cost" of an annuity contract can in many instances be materially greater than the "cost" to an employee or

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[10] KENNETH BLACK, JR. ET AL., LIFE INSURANCE 602-603 (14th ed. 2013).

[11] Longevity annuities often do not provide a death benefit, thereby maximizing the amount of lifetime income that can be purchased from a dollar of premium.

IRA owner of purchasing a simple and uninsured financial instrument such as shares in an index fund. Thus, the criticism sometimes lodged at annuity products for higher relative fees overlooks the fact that the fees pay for not only the costs associated with selling the product, but more importantly, the valuable insurance benefits that annuities offer by protecting individuals against a variety of risks they face in retirement, features that are not available with other investments.

The risks that annuity insurers assume in issuing annuity products include the following:

- <u>Longevity and mortality risk</u>. Annuity insurers assume longevity risk, which is based on mortality rates. Insurers project mortality rates using actuarial tables and making adjustments for the type of product, the demographics of the insurer's customer base, and the market in which the product is sold. If actual mortality rates differ from those the company projects, the company could need to pay out more in benefits than the assets it holds in support of those benefits.

- <u>Adverse selection risk</u>. Long-term experience has shown that individuals who purchase annuities live longer than the population at large. In other words, individuals with poor health tend not to purchase annuities, so as a group those who voluntarily purchase annuities tend to live longer than non-purchasers. As a result, insurance premiums must be set high enough to compensate insurers for the relatively long period during which they will have to make annuity payments. Also, individual mortality rates are generally lower than group mortality rates, which means that annuities purchased in the individual market typically have higher costs for the insurer than those purchased in the group market, *i.e.*, as a group, individuals who purchase a life annuity live longer than the general population.

- <u>Investment risk</u>. Annuity insurers assume investment risk in a variety of ways. They use the premiums they receive to make investments, which must retain sufficient principal and generate sufficient income to offset all of the insurer's costs in issuing and servicing the contracts, paying the benefits promised thereunder, and providing an adequate profit or return on the capital the insurer dedicates to its annuity business lines.

    - Managing this investment risk is particularly challenging for benefits such as GLWBs, which require sophisticated hedging strategies using complex derivatives and extensive modeling of potential financial market outcomes over time, and can generate benefit obligations that fluctuate inversely with severe market downturns.

    - In addition, many of the guarantees that insurers provide are based on expectations of future interest rates, which can fluctuate greatly over the long durations that the insurer's guarantees are in effect. For example, the issuer of a deferred annuity guarantees that the owner will have the right at any time throughout the life of the contract to convert at a specified price the savings accumulated in the annuity to a stream of periodic payments that will then continue for as long as the owner lives. The specified price reflects an assumption about future interest rates.

- Disintermediation risk. Annuity insurers assume disintermediation risk, which is the risk that a large number of fixed deferred annuity policyholders will surrender their contracts during a period in which the market values of assets in the insurer's investment portfolio are depressed. Because the surrender values of the contracts could be greater than the market value of the insurer's assets, the insurer would need to pay out more in cash than it obtained in premiums and investment income. For this reason, some contracts contain "market value adjustments," which allow the insurer to guarantee a higher rate of interest as long as the contract is held for a specified period.

- Expense risk. Annuity insurers guarantee that the expenses they will charge under an annuity contract will not exceed a specified maximum level, regardless of the expenses the company actually incurs in administering the product and providing the benefits thereunder.

Premiums and other charges plus the investment returns on retained funds must be adequate to fund the current and future benefits that an annuity insurer promises under the contracts it issues, as well as related expenses, taxes, contingencies and profits.[12] In other words, annuity products must be designed and priced so that the insurer can satisfy the guarantees for many years into the future. Indeed, state insurance laws mandate that insurers hold sufficient assets to ensure their claims-paying ability. Such state law requirements are intentionally conservative (to assure policyholders will receive their contractual benefits), requiring extensive capital outlays that insurers must generate from the premiums, charges, and investment returns they receive in connection with the contracts they issue.

The typical types of fees and charges that annuity insurers impose and for what purpose are discussed more specifically next.

B. Deferred Fixed Annuities and Deferred Fixed Indexed Annuities

In general, traditional fixed and fixed indexed annuities do not expressly impose periodic expense charges, although surrender charges may apply to withdrawals taken from the contract or on a full surrender of the contract, as discussed below. Insurers do not expressly impose periodic charges because the company expects to recoups its costs (and make a profit) through the "spread" between the interest rate it credits to the contract's account value and the interest and earnings it receives on the premiums it invests through its general account. This is the same mechanism that banks and other financial institutions use to cover their expenses and make a profit under interest-bearing accounts they maintain for their customers. Because the annuity insurer guarantees a minimum interest crediting rate under a fixed annuity over the duration of the contract, the insurer will suffer a loss if the interest and earnings it actually receives on the premiums it invests are insufficient to cover the promised benefit and direct expenses.

C. Deferred Variable Annuities

Unlike the case of fixed annuities, variable annuities expressly impose one or more types of fees. This is different than a fixed annuity because, in the case of a variable annuity, the

[12] *See* Black *supra* note 10, at 378.

earnings (and losses, if any) on the premiums invested in the insurer's separate account are directly passed through to the policyholder. Thus, there is no interest rate "spread" from which the insurer can recoup its expenses or make a profit. The fees and charges commonly associated with variable annuities include:

- Mortality and expense risk charges ("M&E fees"). In most contracts, the M&E fee is designed to compensate the insurer for three important insurance guarantees: (1) the guaranteed purchase rates at which the individual can elect a life-contingent annuity payout at any time, (2) a death benefit to protect the individual's heirs in the event of an unexpected death, and (3) the guarantee that the charges the insurer imposes for contract expenses will never increase above a specified maximum level, even if the insurer's actual expenses do. As discussed above, these guarantees persist for the duration of an annuity contract, which can span 30 years or more for any given policyholder. (Revenues from M&E fees, however, can also be used to help pay for distribution expenses and can be a source of profit to the insurer.)

- Administrative charges. These pay for all of the services associated with administering variable annuity contracts, such as the preparation of contract statements and mailings, and other customer services.

- Mutual fund fees and expenses. Variable annuities are supported by separate accounts that typically invest in mutual funds. Those mutual funds incur investment management fees and operating expenses, and in many cases, distribution charges known as "12b-1 fees." The investment management fees for the types of mutual funds that insurers hold in their separate accounts can be lower than those charged for publicly-offered mutual funds. These lower fees have the effect of offsetting, to some extent, the insurance charges that are imposed under a variable annuity. The manner in which the distribution charges are paid varies. Some of the more common structures are:

    - A-share products. A-share variable annuities have up-front sales charges and no surrender charges. The amount of the up-front sales charge that is applied against each premium may decrease over time as more premiums are paid. A-share contracts often have lower M&E fees than those with surrender charges.

    - B-share products. B-share variable annuities have no up-front sales charge but do impose a surrender charge. As discussed in more detail in part F below, surrender charges generally are imposed only if within a specified timeframe after the contract is issued the owner terminates the contract or takes a significant withdrawal. This is the most common type of variable annuity product.

    - C-share products. C-share variable annuities do not impose surrender charges or up-front loads. Instead, selling costs are recouped through an upward adjustment to M&E fees.

D. Deferred Registered Indexed Annuities

In general, like traditional fixed and fixed indexed annuities, registered indexed annuities do not expressly impose expense charges, although surrender charges may apply to certain withdrawals and full surrenders, as discussed below. Insurers do not expressly impose periodic charges because the company expects to recoup its costs (and make a profit) through the "spread" between the indexed performance adjustments it makes to the contract's account value and the interest and earnings it receives on the premiums it invests and the hedges it uses to support the product.

E. Fees for Additional Insurance Benefits

As discussed above, some annuities permit the owner to add optional benefits to their contracts for an additional charge. These include benefits like GLWBs, which often are offered as riders to a more basic variable or fixed indexed annuity contract. Such additional benefits, whether provided through a rider or as part of the base contract itself, typically have separately-stated fees that are assessed periodically against the annuity contract's account value. The fees compensate the annuity insurer for the significant additional risks it assumes under the benefit promises it makes.

The potential liabilities relating to benefits like a GLWB are significant. This is because such benefits insure against a catastrophic risk that, if realized, is likely to affect a large number of insured individuals. This is the opposite of most insurance risks that life insurers assume. For example, mortality risk involves an event (death) that is certain to occur, but which in any given time span will affect only a small number of insureds from a very large group. In contrast, while GLWBs include a longevity risk component, they also protect against severe market downturns, which, if they occur, can simultaneously affect virtually every individual who purchased the benefit, thereby requiring the insurer to pay out substantial benefits within a short time. This obviously presents additional risk to the insurer, and it must hold sufficient capital to cover that risk, if and when it materializes, and to cover the costs of the financial hedges the insurer enters into to manage the liabilities.

Unfortunately, the liabilities that insurers assume in providing GLWBs and similar benefits are often overlooked in discussions of their associated fees. Because such benefits protect against catastrophic events that, while potentially devastating to the retirement security of millions of Americans, are relatively rare in occurrence, critics tend to focus on how the fees affect returns under the contract during the "good times" in which the catastrophic event has not occurred. As one well-respected textbook on insurance has observed:

> The fees associated with VAs in general and GLBs in particular have been characterized as excessive by some. Other criticisms are similar to those associated with index annuities; the amount of potential gain sacrificed in return for the guarantees is too great relative to their underlying value. Guarantee performance during

> the global equity market declines of 2008-2009 do not support this view.[13]

The same textbook observes that researchers who examined economic aspects of GMWBs found that the benefit of the guarantee is substantial in times of market distress. They examined the hypothetical performance of variable annuities with a GMWB during the generally rising market for equities from 1979 through 1999 and during the falling markets of 2000 through 2008. The account balance and benefit base (the guaranteed withdrawal amount) grew at the same pace during the years of rising markets, but during the years of falling markets the benefit base was more than twice the account value.[14] This highlights the substantial economic (and emotional) benefits that such guarantees provide in bad financial times.

In that regard, concern over such potentially catastrophic financial events is a driving motivation for many annuity owners. These individuals elect to purchase GLWBs and similar benefits to eliminate such concerns and to give them confidence to invest in the equity markets throughout retirement, thereby improving their chances for higher returns that can help sustain their financial security for the rest of their lives. Of course, this requires a trade-off between paying the fees necessary for the insurance protection and keeping those fees invested in the account value. For many, this trade-off is more than worthwhile; it is critical to their willingness to *invest*, rather than simply *save*.

In particular, individual annuity owners are overwhelmingly satisfied with their GLWB purchases. Almost nine in ten (87%) consider the GLWB a valuable product feature, and more than three in four (77%) who purchased a GLWB say it was important in their decision to purchase an annuity.[15] More generally:

- 87% of individual annuity owners agree that annuities are "secure and safe;"
- 87% also agree that "[t]he investment and insurance guarantees available in annuities are a very important benefit of the product;"
- 85% agree that "[o]wning an annuity makes them feel more secure in times of financial uncertainty, such as during declines in the stock market;"
- 85% agree that "[a]nnuities can help protect them against losing the money they invest;" and

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[13] *See* Black *supra* note 10, at 139 (14th ed. 2013).

[14] *Id.* at 601 (citing Chen, Peng and Milevsky, *Merging Asset Allocation and Longevity Insurance: An Optimal Perspective on Payout Annuities*, JOURNAL OF FINANCIAL PLANNING (Feb. 2010)).

[15] The Committee of Annuity Insurers, *Survey of Owners of Individual Annuity Contracts*, at 11 (The Gallup Organization and Mathew Greenwald & Associates 2013) *available at* http://www.annuity-insurers.org/wp-content/uploads/2013/10/2013-Gallup-Survey.pdf. This survey is of the owners of non-qualified (after-tax) annuity contracts. However, there is no reason to believe that an employee or an IRA owner with a GLWB benefit would have any different views of a GLWB.

- 82% agree that "[b]eing able to invest in the stock market through annuities and still get guaranteed income for life adds to the financial security of retirees."[16]

F. Surrender Charges

An insurance company incurs a variety of costs when it issues an annuity. These costs include commission and other distribution expenses. The amount of the commissions and expenses vary with the product and the distribution channel. However, all annuities are inherently long-term products with a variety of protection features, as described above. This requires sales agents to spend a considerable amount of time learning about the particular products they offer for sale and explaining the features (and alternatives) to customers. The insurer must compensate the sales agent for these efforts and recover the costs of doing so. This can be done in different ways, including by imposing a charge at the time the premium or premiums are paid. Indeed, for many years, this was exactly how distribution and other acquisition costs were recovered by life insurance companies. However, few consumers today are willing to pay an up-front charge. As a result, most insurers offer a class of annuity products with a surrender charge.

Surrender charges vary in amount and duration depending on the expenses, including commissions, the insurer incurs in issuing the contract. A key driver of both the amount and duration of surrender charges is that the insurer will invest the premiums it receives for the contracts and then recover its acquisition expenses, either though the earnings on the premiums it invests or through other charges that it assesses under the contract over time. Expenses can be recovered in this manner, however, only if the insurer retains the assets long enough.

In that regard, annuities are marketed and intended to be used as long-term retirement savings and income vehicles. The federal income tax rules recognize this as well, for example by providing tax deferral but penalizing early distributions and imposing other limitations. As a result, issuers expect that purchasers will retain their contracts long enough for the company to recoup all of its up-front expenses. However, if an individual decides not to use the contract for its intended purpose and surrenders the contract (or takes a significant withdrawal) relatively soon after the contract was issued, the company will be unable to recoup all of its up-front costs.

This is why companies impose surrender charges – absent a surrender charge insurers generally must either impose an up-front charge or run the risk of losing money if the contract is terminated earlier than the company expects when it prices the product. By imposing the surrender charge, the company can recover some of its costs in issuing the contract from those owners who do not use the contract for its intended long-term savings purpose without penalizing owners who use their contracts in the intended manner.[17]

III. ANNUITY PRODUCTS ARE HIGHLY REGULATED

The annuity business in the United States is highly regulated by state and federal governments. According to the National Association of Insurance Commissioners ("NAIC"),

[16] *Id.* at 31-32.

[17] *See* Black *supra* note 10, at 34 (14th ed. 2013).

which serves as a vehicle for individual state regulators to coordinate their activities and share resources:

> The fundamental reason for government regulation of insurance is to protect American consumers. State systems are accessible and accountable to the public and sensitive to local social and economic conditions. State regulation has proven that it effectively protects consumers and ensures that promises made by insurers are kept. Insurance regulation is structured around several key functions, including company licensing, producer licensing, product regulation, market conduct, financial regulation and consumer services.[18]

A. Annuity Contract Requirements

An annuity contract form must be filed with the insurance department of every state in which the contract will be issued. This filing requirement also applies to accompanying materials, such as applications, endorsements, riders, and amendments. Most states also impose readability requirements under which annuity contracts must meet certain standards in form and content to ensure that the contract's terms and benefits are understandable to consumers.

B. State Licensing Requirements

Only state-licensed insurance companies can issue commercial annuities. To become licensed, a company must, *inter alia*, demonstrate that it has complied with the necessary capital and surplus and other financial requirements of state law. Some states also require special licenses for the sale of certain types of products, such as variable annuities. In addition, any person who solicits, sells, negotiates, or procures an annuity contract for another person must be licensed as an insurance agent or broker. An agent's license can be revoked or suspended for a variety of reasons, including engaging in business practices that are fraudulent, dishonest, or demonstrate incompetence.

C. State Marketing and Sales Requirements

State insurance regulations also address how life insurance companies can advertise their annuity products. These rules generally are intended to ensure that the format and content of any advertising materials is not misleading, deceptive, or confusing. This is measured using the standard of what impression and effect the materials would reasonably have on a person not knowledgeable in insurance matters.

In addition, suitability requirements apply to sales of annuity products. Under the NAIC Suitability in Annuity Transactions Model Regulation (Model 275), which most states have adopted, there are express training obligations imposed on insurers and insurance producers with respect to annuity products. These are intended to ensure that licensed insurance producers

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[18] NAIC, *State Insurance Regulation: History, Purpose and Structure* (available at: http://www.naic.org/documents/consumer_state_reg_brief.pdf).

understand annuity products generally and also understand the annuity products issued by a specific insurer. The insurer's supervisory system also must include product-specific training that explains all the material features of its annuity product to its licensed insurance producers.

Many states also have adopted the NAIC's Annuity Disclosure Model Regulation (Model 245), which requires the delivery of an appropriate "Buyer's Guide" and disclosure document to the annuity purchaser to assist with understanding the annuity product. Finally, to the extent that the annuities being offered are variable annuities sold through a broker-dealer, FINRA imposes ongoing continuing education requirements.

State insurance laws also regulate transactions in which one annuity contract is replaced by another, such as in an exchange, direct transfer, or rollover. Many states require certain procedures be followed before the issuance of a replacement annuity contract. IRAs are subject to these requirements, although exemptions may apply for certain types of group annuities and annuities issued to qualified plans. In order to reduce the opportunity for misrepresentation or unfair practices, many states also require that a special notice be provided to a customer in a replacement transaction. The notice generally discusses important information that the customer should consider before replacing a contract. In some cases, the notice also will include a comparison of the values and costs of the contracts involved. In addition, customers who replace their annuity contracts generally are given a longer period in which to revoke their contracts after issuance.

D. Securities Law Requirements

In addition to state insurance regulatory requirements, variable annuities and certain other types of annuities that are securities (principally because they do not meet the requirements of state insurance standard non-forfeiture laws for individual deferred annuities) are subject to federal securities laws and regulations.

1. Securities Act of 1933

Variable annuities and certain other annuities that are securities and offered in the retail and IRA markets generally must be registered with the Securities and Exchange Commission ("SEC") under the Securities Act of 1933, as amended. The SEC reviews registration statements (principally the prospectuses contained within them) and requires annual, or if necessary more frequent, amendments to them. For registered products, the issuer must provide the purchaser with a prospectus and update that prospectus regularly. Prospectuses also are required for the underlying mutual funds or other investment options offered under variable annuities. Exceptions to these registration and prospectus delivery requirements are available for annuity contracts that are securities but which are issued in connection with qualified plans or as "private placements." However, these exceptions are not available for IRA annuities or individual section 403(b) annuities unless the purchasers are accredited investors as defined by the SEC.

Prospectuses for variable annuities and other registered annuities, such as registered index annuities and market value adjusted annuities, must disclose a variety of information intended to ensure that the customer fully understands the benefits, guarantees, risks, and costs associated with the contract. These include disclosure of the maximum charges for all contract fees and expenses. Variable annuities must show the range of total operating expenses for the underlying funds offered with the contract. In addition, prospectuses for variable and other registered annuities must provide numerical examples of applicable fees, based on specified assumptions.

2. Securities Exchange Act of 1934

The Securities Exchange Act of 1934 generally requires that variable annuities and other annuities that are securities be distributed through registered broker-dealer firms and their registered representatives, which themselves are subject to extensive regulation regarding capital requirements, reporting, recordkeeping, supervision, advertising, and sales activities. Registered broker-dealer firms also must be members of FINRA, a self-regulatory organization overseen by the SEC. FINRA imposes additional layers of regulation, including supervisory, suitability, advertising, recordkeeping, and reporting rules.

3. Investment Company Act of 1940

The Investment Company Act of 1940 imposes an extensive federal regulatory regime on "investment companies," which include variable annuity separate accounts and their underlying mutual fund or other investments. Exceptions apply to separate accounts used exclusively to fund annuity contracts issued in connection with qualified plans. The 1940 Act requirements govern how variable annuities are issued and redeemed, and the 1940 Act sets forth a specific standard applicable to variable annuity fees and charges. Variable annuities also are subject to 1940 Act requirements regarding voting rights, prohibitions on self-dealing, and recordkeeping and reporting requirements.

4. Advertising and Customer Communications

SEC rules also govern the advertising of annuities that are securities. For variable annuities, these rules generally focus on how past performance of a variable annuity or underlying fund is presented, requiring the reflection of certain standardized formulas and certain specified disclosures and legends. The annuity insurer also must provide updated performance information upon request.

FINRA rules govern broker-dealer communications with the public about variable annuities. Broker-dealer firms that disseminate retail communications about variable annuities must file these communications with FINRA and take into account comments provided by the FINRA advertising department staff.

5. Suitability Requirements

FINRA also imposes suitability, principal review, supervision, and training requirements with respect to annuities that are securities. For variable annuities, many of these requirements are set forth in a rule specifically designed for and applicable only to variable annuities. Under these requirements, a registered representative recommending a variable annuity purchase must have a reasonable basis to believe that (a) the customer has been informed in general terms of various features of a deferred variable annuity; (b) the customer would benefit from certain features of a deferred variable annuity, such as deferred growth, annuitization, or a death or living benefit; and (c) the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated, and riders and product enhancements, if any, are suitable for the particular customer based on required customer information. Additional suitability requirements also apply.

6. FINRA Compensation Requirements

FINRA rules include comprehensive requirements with respect to the payment of compensation for securities transactions, including transactions in variable annuities. Certain other FINRA rules provide requirements applying specifically to the payment of compensation in connection with the sale and distribution of variable insurance products.

Of particular relevance, FINRA Rule 2320 ("Variable Contracts of an Insurance Company") prohibits a FINRA member or its associated person from receiving any non-cash compensation in connection with the sale or distribution of a variable contract, except in limited circumstances subject to very strict requirements. These exceptions may be categorized as either non-incentive based non-cash compensation arrangements or incentive based non-cash compensation arrangements.

The non-incentive based arrangements permit broker-dealer associated persons to receive certain small gifts and occasional meals or entertainment. Such payments may not be preconditioned on reaching any type of sales target. Also, meals and entertainment may not be frequent or extensive. Another non-incentive based exception – again subject to strict requirements – allows product offerors to pay expenses incurred in connection with training or educational seminars or meetings. Payments related to training or educational seminars or meetings may not be preconditioned on reaching any sales target.

Incentive non-cash compensation arrangements are permitted only based upon the total production of an associated person where credit for each variable contract is equally weighted, and the arrangement is between a member and its associated persons or an affiliate of the member and its associated persons.

IV. ANNUITY INSURERS COMPLY WITH STRICT FINANCIAL REGULATORY REQUIREMENTS

In addition to the regulatory requirements discussed above, as well as many others, annuity insurers are subject to strict financial regulatory requirements. The most important of these are the stringent reserve requirements that annuity insurers must satisfy with respect to their benefit liabilities to customers, which are measured using actuarial calculations prescribed by uniform state laws. These requirements, together with associated capital requirements, are designed to protect consumers by ensuring each company's solvency and claims-paying ability, considering the long-term and important promises they make to their customers. While that is both necessary and desirable, the fact is that these reserve and capital requirements affect the cost of the benefits provided under annuity contracts.

Uniform state insurance laws require life insurance companies to determine reserves for their contracts pursuant to prescribed actuarial standards. For annuities, the standard valuation method is the Commissioners' Annuity Reserve Valuation Method, or CARVM. The basic principle of CARVM is that all possible future guaranteed benefit streams must be valued at the end of each year, when the financial report (the annual statement) is filed with state regulators, with the reserves being set equal to the largest of the present values of those future guaranteed benefits. In addition, the reserve with respect to a contract cannot be less than its cash surrender value. The insurer must hold "admitted" assets (see below) at least equal to these reserves, over and above its capital requirements (also discussed below), to be considered solvent and thereby avoid increased solvency supervision by state regulators.

The basic benefits under most deferred annuities consist of an account or cash value and various annuitization benefits. Many deferred annuities, however, also provide additional benefits, all of which must be factored into the reserve calculations. For example, a benefit as simple as a "free withdrawal" benefit, which allows the annuity owner to withdraw a certain amount per year without imposition of a surrender charge, can increase the reserve required for the contract because it eliminates a potential source of funds (the surrender charge) from which the insurer could recoup its costs in issuing the contract, thereby potentially increasing its expenses. Likewise, ROP death benefits, enhanced death benefits, extended interest rate guarantee periods, GMWBs, GLWBs, GMABs, and every other form of guaranteed benefit under a contract must be reflected in the reserve calculations and can increase the required reserve and capital requirements.

The result is that in a number of cases the assets the company will be required to maintain in support of its liabilities can exceed the cash surrender values of the contracts. Also, in connection with their annual statement filings with state regulators, life insurance companies are required to conduct an asset adequacy analysis, *i.e.*, to measure the adequacy of the assets to meet the company's obligations under the annuity contracts it has issued. The process typically models the insurer's assets and liabilities, including the expected behavior of policyholders under various economic scenarios. The resulting cash flows are compared to the cash flows projected to be needed to fund claims, surrenders, expenses, and other liabilities. If the projected cash flows are insufficient to meet the projected liability cash flows, the reserves are considered inadequate and must be strengthened by diverting part of the company's surplus holdings to its contract reserves.

In addition, the types of assets life insurance companies can hold to fund their reserve and capital requirements are regulated under state laws, and certain types of assets – those not "admitted" because they do not meet certain conservative safety standards – cannot be counted in determining the adequacy of the assets backing insurers' liabilities. In addition, most life insurers are required by state regulators to hold risk based capital that is six to seven times greater than the minimum capital they are required to hold for solvency alone. (Financial rating agencies also look to an insurer's risk based capital to assess its claims-paying ability and its overall value.) Finally, the books and records of life insurers are reviewed by state regulators on a regular basis and subject to required annual independent audits, the costs of which are borne by the insurers.

All of this contributes to the fact that fees for annuity products can sometimes be higher than for other types of financial instruments, such as mutual funds, which do not provide insurance benefits and are not subject to state law reserve and capital requirements placed on insurers. In other words, life insurers' reserve and capital requirements affect the cost of the benefits provided under annuity contracts. By way of example, a long-term interest rate guarantee embedded in an annuity contract will significantly increase the required reserve, meaning that the insurer will need to charge more for the product with such a guarantee in order to collect sufficient sums to fund its reserve liabilities. Likewise, other insurance benefits and guarantees provided under a contract can increase the insurer's required reserve and capital and, hence, the cost of the product it provides. Life insurers' reserve and capital requirements restrict their ability to use their resources for other purposes, such as funding new business, developing new products, making long term business investments in systems, making acquisitions, or paying policyholder or shareholder dividends. These requirements, in other words, have a real financial impact on insurers, a fact that significantly contributes to the cost (and availability) of annuity product offerings.