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ANNUITY STANDARD OF CONDUCT

House Bill 6112 as reported from committee
Sponsor: Rep. Brenda Carter

House Bill 6113 (H-1) as reported from committee
Sponsor: Rep. Ryan Berman

House Bill 6114 as reported
Sponsor: Rep. Gregory Markkanen

House Bill 6115 (H-1) as reported
Sponsor: Rep. Daire Rendon

1st Committee: Insurance
2nd Committee: Ways and Means
Complete to 12-2-20

SUMMARY:

House Bills 6112 to 6115 would amend the Insurance Code to change the standard of conduct for the recommendation and sale of annuities by insurance agents.[1] Under Chapter 41A (Annuity Recommendation to Consumers), an agent now must reasonably ensure that an annuity is "suitable" for a consumer based on certain information. The bills would instead require the agent to ensure that the annuity is in the consumer's "best interest." The obligations imposed by each of these standards are described below. Chapter 41A is based on a model law from the National Association of Insurance Commissioners (NAIC); the bills reflect recent changes to that model law.[2]

Annuities

As described by the NAIC, "An annuity is an insurance contract typically used in retirement planning and designed to protect an individual from outliving his or her assets. An individual, or annuitant, pays premiums into the annuity and the insurer promises to pay out money from the annuity to the annuitant or a beneficiary in a series of payments."[3] Often the premium paid by the annuitant is a lump sum, for example in investing one's savings to provide an income stream after retirement. Under a deferred annuity, premiums are paid and accumulated for some time before any money is paid out. Because of how they are structured, annuities typically provide for low liquidity: they must tie money up to make it perform as contracted, and there are usually cancellation and withdrawal penalties. Taxes are generally deferred on money paid into an annuity and assessed on what is paid out.

There are different kinds of annuities.[4] Fixed annuities provide periodic payments of a specific amount over either a set time period or an indefinite period such as the lifetime of the annuitant.

[1] Although this summary mostly refers to insurance agents, note that the standards of conduct in both current law and under the bills apply to the insurance company if no agent is involved in the transaction. Note, too, that the Insurance Code generally calls insurance companies "insurers" and insurance agents "producers."
[2] See https://www.naic.org/documents/cmte_legislative_liaison_brief_annuity_suitability.pdf
[3] See https://www.naic.org/documents/government_relations_annuities_issue_brief.pdf
[4] For an overview, see https://www.investor.gov/introduction-investing/investing-basics/glossary/annuities or https://www.michigan.gov/documents/difs/FIS-PUB_5800_573249_7.pdf

This basic framework can be modified to provide, among other things, for inflation-adjusted payments or for payments that will continue to be paid to a beneficiary after the annuitant's death. Indexed annuities pay out a return that is based on a stock market index, such as the Standard & Poor's 500 Index. Variable annuities allow premiums to be invested in the stock and bond markets, usually through mutual funds, with payouts that then vary based on the performance of those investments. Because of their underlying risk, the U.S. Securities and Exchange Commission (SEC) classifies variable annuities as securities rather than life insurance products; insurance agents must meet additional requirements to sell them.[5]

Applicability of the chapter

Under both current law and the bills, Chapter 41A applies to a group or individual annuity that is individually solicited. It does not apply to certain specified transactions, including direct response solicitations that do not make a recommendation based on information from a consumer; employee pension and welfare benefit plans covered by the Employee Retirement and Income Security Act (ERISA); employer profit-sharing and pension plans and government and private employer deferred compensation plans covered under the Internal Revenue Code; settlements of personal injury litigation or any dispute or claim resolution process; and formal prepaid funeral contracts.

"Suitability" standard (current law)

Currently, Chapter 41A applies only to recommendations (advice given by an insurance agent to a particular consumer) that actually *result in* the recommended purchase, exchange, or replacement of an annuity. An agent must have reasonable grounds to believe that such a recommendation is suitable for the consumer based on facts disclosed by the consumer about his or her investments, insurance, and financial situation and needs—including his or her ***suitability information***—before the agent can issue the annuity. The agent must make reasonable efforts to obtain suitability information before finalizing the transaction.

> ***Suitability information*** means information about a consumer that is reasonably appropriate to determine whether a recommendation is suitable for him or her. It includes all of the following:
>
> - Age.
> - Annual income.
> - Financial situation and needs, including the resources used to fund the annuity.
> - Financial experience.
> - Financial objectives.
> - Intended use of the annuity.
> - Financial time horizon.
> - Existing assets, including investment and life insurance holdings.
> - Liquidity needs.
> - Liquid net worth.
> - Risk tolerance.
> - Tax status.

[5] See https://www.michigan.gov/difs/0,5269,7-303-22535_23032-239476--,00.html

The agent must also have reasonable grounds to believe all of the following:

- That the consumer has been reasonably informed of certain features of the annuity, such as market risk, potential surrender period, potential tax penalty, and certain specified fees, charges, and limitations. (During a "surrender period" an annuitant cannot withdraw money from the annuity without payment of a charge or fee.)
- That the consumer would benefit from certain features of the annuity.
- That the particular annuity and the transaction as a whole are suitable for the consumer based on his or her suitability information.

"Best interest" standard (proposed by the bills)

Under the bills, Chapter 41A would apply to recommendations that are *intended* to result in a purchase, exchange, or replacement of an annuity, as well as those that actually have that result. The following would not be "recommendations" under the chapter:

- General communication to the public.
- Generalized customer services assistance or administrative support.
- General educational information and tools.
- Prospectuses.
- Other product and sales material.

House Bill 6113 would delete the "suitability" requirements now in law and instead require an insurance agent recommending an annuity to act in the best interest of the consumer, under the circumstances known at the time, without placing the agent's or insurance company's financial interest ahead of the consumer's interest.

An agent would meet this standard if, in making a recommendation, the agent exercised reasonable diligence, care, and skill to do all of the following:

- Know the consumer's financial situation, insurance needs, and financial objectives.
- Understand the available options. (This would not require an agent to consider products or strategies beyond what the agent is authorized to recommend or sell.)
- Have a reasonable basis for believing that the recommended option effectively addresses the consumer's financial situation, insurance needs, and financial objectives, as evaluated in light of his or her ***consumer profile information***. All of the following would apply in meeting this requirement:
    - The agent must make reasonable efforts to obtain consumer profile information from the consumer before making an annuity recommendation.
    - The generally relevant factors to consider are consumer profile information, characteristics of the insurance company, and annuity costs, rates, benefits, and features. The weight given to each factor may vary on a case-by-case basis, but these factors must always be considered together and not in isolation.
    - The agent also must have a reasonable basis for believing that the consumer would benefit from certain features of the annuity, such as annuitization, death or living benefit, or other insurance-related features.
- Communicate the basis for the recommendation.

    Consumer profile information would mean information about a consumer that is reasonably appropriate to determine whether a recommendation addresses his or her financial situation, insurance needs, and financial objectives. This information would

be nearly the same as "suitability information" in current law. It would include at least all of the following:

- Age.
- Annual income.
- Financial situation and needs, including debts and other obligations.
- Financial resources used to fund the annuity.
- Insurance needs.
- Financial experience.
- Financial objectives.
- Intended use of the annuity.
- Financial time horizon.
- Existing assets or financial products, including investment, annuity, and insurance holdings.
- Liquidity needs.
- Liquid net worth.
- Risk tolerance, including willingness to accept ***nonguaranteed elements*** in the annuity.
- Tax status.

Nonguaranteed elements would mean the premiums, credited interest rates (including any bonus), benefits, values, dividends, non-interest-based credits, or charges, or elements of formulas used to determine any of these, that are subject to company discretion and are not guaranteed at issue. An element would be considered nonguaranteed if any underlying nonguaranteed elements were used to calculate it.

An insurance company could not issue an annuity recommended to a consumer without a reasonable basis for believing, based on the consumer's consumer profile information, that the annuity would effectively address the consumer's particular financial situation, insurance needs, and financial objectives.

The above standards would apply to the annuity as a whole, the underlying subaccounts where funds would be allocated when the annuity is purchased or exchanged, and any riders or similar product enhancements. They would not require the agent to recommend the annuity with the lowest one-time or multiple occurrence compensation structure.

Exchanging or replacing an annuity

Currently, for the exchange or replacement of an annuity, the insurance agent must additionally have a reasonable basis to believe that the exchange or replacement is suitable considering all of the following:

- Whether the consumer will incur a surrender charge; be subject to the commencement of a new surrender period; lose existing benefits such as death, living, or other contractual benefits; or be subject to increased fees, investment advisory fees, or charges for riders and similar product enhancements.
- Whether the consumer would benefit from product enhancements and improvements.
- Whether the consumer has had another annuity exchange or replacement, particularly within the past three years.

House Bill 6113 would instead require that the agent additionally consider the whole transaction for an exchange or replacement, including the following:

- Whether the consumer will incur a surrender charge; be subject to the commencement of a new surrender period; lose existing benefits such as death, living, or other contractual benefits; or be subject to increased fees, investment advisory fees, or charges for riders and similar product enhancements. (This is the same as current law.)
- Whether the replacing product would substantially benefit the consumer compared to the replaced product over the life of the product.
- Whether the consumer has had another annuity exchange or replacement, particularly within the past five years.

Disclosures

House Bill 6113 would require an insurance agent to prominently disclose to a consumer the following information, on a form issued by the director of the Department of Insurance and Financial Services (DIFS), before recommending or selling an annuity:

- A description of the scope and terms of the agent's relationship with the consumer and the role of the agent in the transaction.
- An affirmative statement of whether the agent can sell the following:
    - Fixed annuities.
    - Fixed indexed annuities.
    - Variable annuities.
    - Life insurance.
    - Mutual funds.
    - Stocks and bonds.
    - Certificates of deposit.
- An affirmative statement describing the insurance companies whose products the agent can sell, using these descriptions:
    - One insurance company.
    - Two or more insurance companies.
    - Two or more insurance companies, although primarily contracted with one insurance company.
- A description of the sources and types of ***cash compensation*** and ***noncash compensation*** the agent will receive, including whether the agent will be compensated by commission or by fee.
- A notice of the consumer's right to request additional information regarding cash compensation, as described below.

    Cash compensation would mean any discount, concession, fee, service fee, commission, sales charge, loan, override, or cash benefit received by an agent in connection with the recommendation or sale of an annuity from an insurance company or ***intermediary*** or directly from the consumer.

    Noncash compensation would include such things as health insurance, office rent, office support, and retirement benefits.

    Intermediary would mean an entity contracted to facilitate the sale of an insurance company's annuities by insurance agents.

If requested by the consumer or his or her representative, an agent would have to disclose both of the following:

- A reasonable estimate of the amount of cash compensation the agent will receive, which could be stated as a range of amounts or percentages.
- Whether the cash compensation is a one-time or multiple occurrence amount and, if multiple, the frequency and amount of the occurrence, which could be stated as a range of amounts or percentages.

An agent would also have to identify and avoid or reasonably manage and disclose ***material conflicts of interest***, including those related to an ownership interest.

> ***Material conflict of interest*** would mean an agent's financial interest in the sale of an annuity that a reasonable person would expect to influence the impartiality of a recommendation. It would not include cash or noncash compensation.

When making a recommendation or sale, the agent would have to have a reasonable basis for believing that the consumer has been informed of various features of the annuity, such as the potential surrender period and surrender charge, the potential tax penalty if the consumer sells, exchanges, surrenders, or annuitizes the annuity, mortality and expense fees, investment advisory fees, any annual fees, potential charges for and features of riders or other annuity options, limitations on interest returns, potential changes in nonguaranteed elements of the annuity, insurance and investment components, and market risk.

Scope

House Bill 6113 would specify that the "best interest" requirements create only a regulatory obligation as established under Chapter 41A and do not create a fiduciary obligation or relationship.

The requirements would apply only at the time of the recommendation or sale. They would not impose an ongoing monitoring obligation on an insurance agent—but they also would not prevent that obligation from being separately imposed under a fiduciary, consulting, investment advising, or financial planning agreement.

The requirements would apply to each agent who exercised material control or influence over a recommendation and who received direct compensation from a recommendation or sale, whether or not that agent had direct contact with the consumer. General supervision or activities such as providing or delivering marketing or educational materials, product wholesaling, or other back office product support would not by themselves constitute "material control or influence."

House Bill 6112 would specify that the obligations imposed by Chapter 41A do not require an agent to get a license other than one with the appropriate line of authority to sell, solicit, or negotiate insurance in this state as long as the agent does not give advice or provide services that are otherwise subject to securities laws or engage in any other activity requiring other professional licenses.

Exceptions
Both current law and the bills provide that their respective standard of conduct provisions do not apply to an annuity transaction under any of the following circumstances:

- A recommendation is not made.
- A recommendation is found to have been based on materially inaccurate information provided by the consumer.
- The consumer refuses to provide relevant suitability information and the annuity transaction is not recommended.
- The consumer decides to enter into an annuity transaction that is not based on the insurance agent's recommendation.

However, an insurance company's issuance of an annuity under the above exceptions would have to be reasonable under all the circumstances actually known to the insurance company at the time.

Records
Currently, at the time of an annuity sale, the insurance agent must make a record of any recommendation. If a consumer refuses to provide any suitability information, the agent must obtain a statement signed by the consumer that documents that refusal. If a consumer decides to enter into an annuity transaction that is not based on the agent's recommendation, the agent must obtain a statement signed by the consumer that acknowledges that the transaction is not recommended.

House Bill 6113 would retain these provisions, with three changes. First, in addition to recording any recommendation, the agent would also have to record the basis for the recommendation. Second, those records would have to be written records. Third, the signed statement documenting a consumer's refusal to provide consumer profile information would also have to document the consumer's understanding of the ramifications of not providing that information.

Insurer supervision system
An insurance company now must establish a supervision system that is reasonably designed to ensure compliance with Chapter 41A, including all of the following:

- Reasonable procedures to inform its insurance agents of the chapter's requirements.
- Inclusion of those requirements in relevant training materials.
- Reasonable procedures to ensure that agents comply with required training courses.
- Standards for product training.
- Training and materials that explain all material features of its specific annuity products.
- Procedures for review of each recommendation before issuance of an annuity.
- Reasonable procedures to detect recommendations that do not comply with the chapter.
- An annual review and report on the supervision system's effectiveness.

House Bill 6113 would add that a supervision system must also include the following:

- Reasonable procedures to assess whether an agent has provided information to the consumer as required.
- Reasonable procedures to identify and address suspicious consumer refusals to provide consumer profile information.

- Reasonable procedures to identify and eliminate any sales contests, sales quotas, bonuses, and noncash compensation that are based on the sales of specific annuities within a limited period of time.

Chapter 41A currently provides that an insurance company's supervision system does not have to include an agent's recommendations of products other than annuities the insurance company offers. The bill would add that the system also does not have to include consideration of or comparison to options available to the agent, or compensation relating to those options, other than products the insurance company offers.

Training requirements

Currently, an insurance agent who sells annuities must complete a one-time four-credit course approved by the director of DIFS.[6] The training includes information on such things as the types and various classifications of annuities; the primary uses of annuities; how fixed, variable, and indexed annuity contract provisions affect consumers; the income taxation of qualified and nonqualified annuities; and appropriate sales practices and replacement and disclosure requirements.

House Bill 6114 would additionally require the training to include information on the "appropriate standard of conduct." An agent who had completed a training course before the bill took effect would have to complete either a new four-credit course or an additional one-time, one-credit course on the appropriate sales practices, replacement, and disclosure requirements under Chapter 41A as amended by the bills. The chapter's training requirements could also be satisfied by completing a course with substantially similar components.

Comparable standards

Both current law and the bills contain "safe harbor" provisions to ensure that financial professionals who sell annuities under the standards of professional conduct that apply to them are not found to be acting in violation of Chapter 41A in doing so.

The law currently provides that an annuity sale that meets financial industry regulatory authority requirements for the suitability and supervision of annuity transactions also meets the requirements of Chapter 41A. This provision applies to a financial industry regulatory authority broker-dealer sale of a variable or fixed annuity if the suitability and supervision are similar to those applied to variable annuity sales. The provision applies as long as the insurance company monitors the financial industry regulatory authority member broker-dealer using information collected in the normal course of business and provides the broker-dealer with appropriate information to help it maintain its supervision system.

House Bill 6115 would amend this provision. Under the bill, a recommendation or sale that complied with ***comparable standards*** would satisfy the requirements of Chapter 41A. This provision would apply to a recommendation or sale of an annuity made by a ***financial professional*** under business rules, controls, and procedures that satisfy a comparable standard even if the standard would not otherwise apply to that product or recommendation. The provision would apply as long as the insurance company monitored the relevant conduct of the financial professional or an entity supervising the financial professional using information

[6] See https://www.michigan.gov/difs/0,5269,7-303-13648_60666_77177---,00.html

collected in the normal course of business and provided the supervisory entity with appropriate information to help it maintain its supervision system.

Financial professional would mean an insurance agent that is regulated and acting as any of the following:

- A broker-dealer registered under federal securities laws or a registered representative of a broker-dealer.
- An investment adviser registered under federal securities laws or an associated investment adviser representative.
- A fiduciary under the Internal Revenue Code (26 USC 4975) or a plan fiduciary under ERISA (29 USC 1002).

Comparable standards would mean the following, as applicable:

- For broker-dealers and registered representatives, applicable SEC and Financial Industry Regulatory Authority (FINRA) rules concerning best interest obligations and supervision of annuity recommendations and sales.
- For investment advisers or investment adviser representatives, the fiduciary duties and all other requirements imposed by contract or under the Investment Advisers Act of 1940.
- For fiduciaries or plan fiduciaries, the relevant duties, obligations, prohibitions, and other requirements under the Internal Revenue Code or ERISA.

The above provisions would not limit an insurance company's obligation to issue an annuity recommended to a consumer only when the insurance company has a reasonable basis to believe that the annuity would effectively address the particular consumer's financial situation, insurance needs, and financial objectives based on the consumer profile information. An insurance company could base its analysis on information received from the financial professional or supervisory entity.

Both current law and the bills provide that the above provisions do not limit the ability of the director of DIFS to investigate and enforce Chapter 41A.

<u>Violations</u>

House Bill 6112 would add language stating that Chapter 41A does not create or imply a private cause of action for violations of it or subject an insurance agent to civil liability under either fiduciary standards or the "best interest" standard of care.

House Bill 6115 would provide that insurance companies are responsible for compliance with Chapter 41A. If a violation of the chapter occurred because of the action or inaction of an insurance company or its agent, the director of DIFS could do any of the following:

- Order the insurance company to take reasonably appropriate corrective action for a consumer harmed by a violation of the chapter by the insurance company, by an entity contracted to perform the insurance company's supervisory duties, or by the insurance agent.
- Order the insurance agent to take reasonably appropriate corrective action for a consumer harmed by the agent's violation of the chapter.
- Order appropriate sanctions.

The director of DIFS could reduce or eliminate an order described above if appropriate corrective action was taken promptly after the violation was discovered or if the violation was not part of a pattern or practice.

Brief description by bill

House Bill 6112 would amend **definitions** of terms used in Chapter 41A and specify that the **scope of the chapter** does not require additional licensure or create a private cause of action. (MCL 500.4151 and 500.4153)

House Bill 6113 would replace the "suitability" standard with the **"best interest" standard** and amend requirements for **systems of supervision**. (MCL 500.4155 and 500.4158)

House Bill 6114 would amend **training requirements** for insurance agents. (MCL 500.4159 and 500.4160)

House Bill 6115 would address **comparable standards** and the **enforcement** of compliance with the chapter. (MCL 500.4165 and proposed MCL 500.4166)

Enactment provisions

The bills are all tie-barred to one another, which means that none of them could take effect unless all of them were enacted.

Each bill would take effect six months after the date of its enactment.

BACKGROUND:

Insurance regulation in the United States is primarily state-based. The NAIC is a nonprofit organization governed by the chief insurance regulators of every state, the District of Columbia, and the territories of Puerto Rico, Guam, the U.S. Virgin Islands, the Northern Mariana Islands, and American Samoa. The NAIC establishes standards and best practices for the insurance industry, including developing and maintaining model laws, and coordinates regulatory oversight among the states. It promotes certain levels of interstate uniformity in insurance regulation as beneficial to insurers, consumers, and regulators. The NAIC also offers consumer education programs, provides support and training for state insurance officials, and represents state insurance regulators collectively at the national and international levels.[7]

Chapter 41A was added to the Insurance Code by 2006 PA 399[8] and was substantially revised by 2012 PA 544.[9] Both the initial enactment and the 2012 overhaul were based on a model law developed by the NAIC in 2003 (the "Suitability in Annuity Transactions Model Regulation (#275)") and its subsequent revisions and updates.

In February 2020, the NAIC adopted a newly revised version of this model law, which provides the basis for House Bills 6112 to 6115. According to the NAIC, the goal in developing the new model was "to seek clear, enhanced standards for annuity sales so consumers understand the

[7] https://www.naic.org/documents/about_faq.pdf
[8] http://legislature.mi.gov/doc.aspx?2005-SB-0880
[9] http://legislature.mi.gov/doc.aspx?2011-SB-0467

products they purchase, are made aware of any material conflicts of interest, and are assured those selling the products do not place their financial interests above consumers' interests."[10]

The NAIC also tried to align its new model with the SEC's standard of conduct for federally registered broker-dealers and associated persons who are making securities recommendations to consumers.[11] Those rules, known as Regulation Best Interest or Reg BI, were approved on June 5, 2019, and took effect June 30, 2020.[12] Among other things, the standards of conduct for making investment recommendations under both the NAIC model and the SEC regulation are considered to share four "best interest" components: a care obligation, a disclosure obligation, a conflict of interest obligation, and a documentation obligation.

FISCAL IMPACT:

The bills would be unlikely to have an appreciable fiscal impact on the Department of Insurance and Financial Services.

POSITIONS:

Representatives of the following entities testified in support of the bills (9-2-20):

Department of Insurance and Financial Services
American Council of Life Insurers

The following entities indicated support for the bills:

Gleaner Life Insurance Society (9-2-20)
AIG (9-2-20)
Jackson National Life (9-2-20)
John Hancock (9-2-20)
Life Insurance Association of Michigan (12-1-20)
Insured Retirement Institute (12-1-20)
National Association of Insurance and Financial Advisors (12-1-20)

Legislative Analyst: Rick Yuille
Fiscal Analyst: Marcus Coffin

■ This analysis was prepared by nonpartisan House Fiscal Agency staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.

[10] https://content.naic.org/cipr_topics/topic_annuity_suitability_best_interest_standard.htm
[11] See https://www.naic.org/documents/government_relations_180806_comments_sec_annuity_suitability.pdf
[12] See https://www.sec.gov/regulation-best-interest