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September 24, 2015

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: Conflict of Interest Rule – Retirement Investment Advice
Room N-5655
U.S. Department of Labor
200 Constitution Avenue NW
Washington, DC 20210

RE: **RIN 1210-AB32 –** Conflict of Interest Rule – Retirement Advice

ZRIN 1210-ZA25 –Proposed Amendment to and Proposed Partial Revocation of Prohibited Transaction Exemption 84-24

Dear Sir or Madam,

On behalf of NAFA, the National Association for Fixed Annuities[1], I am pleased to have the opportunity to submit these additional comments on the Department of Labor's proposed new definition of a fiduciary and the proposed amendments to Prohibited Transaction Exemption (PTE) 84-24 (collectively, "the proposed rule").

As we made clear in our prior letter, NAFA commends the Department for recognizing that PTE 84-24 is the appropriate regulatory exemption for non-security annuities – i.e., fixed annuities – under the proposed rule. We believe that this is the appropriate exemption because only fixed annuities – unlike all other types and categories of retirement investment vehicles – offer two insurance-backed, contractual guarantees: guaranteed protection of principal and a guaranteed annuitized income payout.

Given the current retirement crisis in the United States, where as many as 68% of all working-age Americans do not participate in an employer-sponsored retirement plan,[2] the Department's inclusion of non-security annuities under PTE 84-24 will encourage the purchase of fixed indexed annuities for the risk-free growth of

[1] Founded in 1998, NAFA is an advocacy trade association, exclusively dedicated to educate and inform state and federal regulators, legislators, industry personnel, media, and consumers about the value of fixed annuities and their benefits to Americans in financial and retirement planning. NAFA's membership includes insurance companies, independent marketing organizations, and individual producers, representing every aspect of the fixed annuity marketplace and covering 85% of fixed annuities sold by independent agents, advisors, and brokers.
[2] http://www.forbes.com/sites/laurashin/2015/04/09/the-retirement-crisis-why-68-of-americans-arent-saving-in-an-employer-sponsored-plan/

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principal and lifetime income feature these products offer. And, within qualified plans, our industry has the best products to provide and fund individual retirements.

NAFA is concerned, however, that there may be confusion regarding the proper understanding of a fixed indexed annuity as a *non-security* annuity product, and thereby eligible under PTE 84-24. In this second comment letter we will explain why fixed indexed annuities are correctly understood and properly categorized as insurance products and are not 'security annuities'. Both state and federal law treat all fixed indexed annuities, including fixed indexed annuities, as purely insurance products, thus exempting them from securities laws or registration. Accordingly, NAFA believes that it is appropriate that the Department continue to include fixed indexed annuities as non-security annuities under the proposed modification to PTE 84-24.

Additionally, NAFA will address several points of clarification or modification that we believe the Department should consider in adopting its final rule. Finally, in response to your request, we propose a specific fixed annuity product class for a streamlined exemption.

I. *All* fixed annuities are insurance products – not investments – and provide insurance guarantees to grow and protect retirement assets and income

<u>A fixed annuity contract is between the consumer and the issuing insurance company</u>

As stated in the NAIC[3] Buyer's Guide for Fixed Annuities, "An annuity is a contract with an insurance company. All annuities have one feature in common, and it makes annuities different from other financial products. ***With an annuity, the insurance company promises to pay you income on a regular basis for a period of time you choose***—including the rest of your life."[4]

[3] The National Association of Insurance Commissioners (NAIC) is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC staff supports these efforts and represents the collective views of state regulators domestically and internationally. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S. http://www.naic.org/index_about.htm
[4] Buyer's Guide for Deferred Annuities – Fixed, prepared by the National Association of Insurance Commissioners (NAIC), as revised 2013 (emphasis in original). State disclosure regulations require that consumers receive a buyer's guide when they purchase an annuity contract. http://www.naic.org/documents/prod_serv_consumer_anb_le_2013.pdf.

Unlike investment vehicles, where the consumer pays the investment advisor – typically on an annual basis – to manage and allocate his or her assets based upon an investment plan developed by the investment advisor and the consumer, a fixed annuity sale is a one-time transaction between the consumer and the insurance company that is facilitated by an agent. The fixed annuity contract itself is a contractual agreement that spells out all terms, conditions and benefits.

All monies are paid directly to the insurance company and are never controlled or managed by the insurance agent. The agent never has access to the assets used to purchase the fixed annuity and cannot alter anything in the annuity contract. Moreover, all of the money used to purchase the annuity contract is credited to the contract account; premium payments are not offset by the payment of commission to the insurance agent.

Fixed indexed annuities are a type of fixed annuity

Generally, fixed annuities can be categorized as either declared rate (or set rate) – i.e., 'traditional' fixed annuities – or fixed indexed annuities. The NAIC considers both types of annuities to be fixed annuities, describing them as follows:

> ***Fixed annuities*** guarantee your money will earn interest at least a minimum interest rate. Fixed annuities may earn interest at a rate higher than the minimum but only the minimum rate is guaranteed. The insurance company sets the rates.
>
> ***Fixed indexed annuities*** are a type of fixed annuity that earns interest based on changes in a market index, which measures how the market or part of the market performs. The interest rate is guaranteed to never be less than zero, even if the market goes down.[5]

Fixed indexed annuities provide the exact same type of contractual guarantees as declared rate annuities – namely, that the annuity policy owner will never lose his or her premium or credited interest due to investment or market risk. Moreover, all fixed annuities are required to follow state-mandated standard non-forfeiture laws, reserving requirements, and disclosure laws.

Additionally, all fixed deferred annuities (including fixed indexed annuities) must provide contractually-guaranteed annuitization payments, as well as the promise that the premium and prior interest earned will not be affected by any negative

[5] *Ibid.*

performance of the insurance company's investment portfolio or any negative performance of the market index.

<u>The only difference between a fixed declared rate and fixed indexed rate annuity is how the contractual interest is determined and calculated</u>

In the case of a declared rate contract, the insurance company determines the interest rate that is to be paid. The annuity contract may allow the insurance company to change the rate as stipulated under the contract, but all declared rate annuities provide a minimum guaranteed interest rate floor, protecting the annuity owner against loss due to investment or market risk. Thus, the annuity owner has a guaranteed level of return that will always provide a guaranteed and predictable level of income.

In the case of a fixed indexed annuity, the credited interest is based on an external market index, such as the S&P 500. The contract does not directly participate in any security investment. The annuity owner is not directly or indirectly buying shares of any stock or index fund and takes on no market risk; instead, the investment risk is shifted to the insurance company.

The advantage of a fixed indexed annuity over declared rate annuity for some retirement consumers is the opportunity to earn more interest growth from favorable changes in the external market index, while ensuring that the annuity owner's contract value will not decrease due to unfavorable changes. Once the interest rate is determined and credited, fixed indexed annuities function in all ways like all other fixed annuities, including the predictable stream of lifetime income that is contractually guaranteed by the insurance company.

These fixed insurance products – both fixed declared rate annuities and fixed indexed annuities – are meant to be long-term retirement savings vehicles. They are not investments. They are not securities.

<u>Fixed indexed annuities are insurance products – not securities – under both state and federal law</u>

Historically, the Securities and Exchange Commission (SEC) has exempted from federal securities regulation any annuity that was not marketed primarily as an investment and for which the insurer assumed the risk of loss.[6] Fixed indexed annuities, which were first introduced in 1995, met these criteria and have always

[6] 17 C.F.R. § 230.151; *see also American Equity Inv. Life Ins. Co. v. S.E.C.*, 613 F.3d 166, 170 (D.C. Cir. 2010).

been considered exempt from federal securities laws and have been regulated at the state level by the state departments of insurance.

In 2010, as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Congress reaffirmed that fixed indexed annuities would continue to be regulated by state insurance departments as insurance products—and not as securities subject to federal oversight. This legislation provided fixed indexed annuities with a safe harbor from federal securities regulation and registration if certain criteria were met, ensuring the continued regulation of these products by state insurance departments.[7]

<u>Fixed indexed annuities are not variable annuities</u>

The NAIC Buyer's Guide describes variable annuities as follows:

> ***Variable annuities*** earn investment returns based on the performance of the investment portfolios, known as "subaccounts," where you [the consumer] choose to put your money. The return earned in a variable annuity isn't guaranteed. The value of the subaccounts you choose could go up and down. If they go up, you could make money. But, if the value of these subaccounts goes down, you could lose money. Also, income payments to you could be less than you expected.

This description by the NAIC highlights a critical distinction between fixed and variable annuities: "[t]he return earned in a variable annuity isn't guaranteed." Indeed, variable annuities are distinguishable from fixed indexed annuities in a number of important ways, including:

- Variable annuities are securities and are regulated as such.

- Fixed indexed annuities are insurance products.

[7] Under the Harkin Amendment to the Dodd-Frank Act (section 989J), fixed indexed annuities are exempt from federal regulation as securities if three criteria are met: (1) the value of the insurance product does not vary according to the performance of a separate account, (2) the product satisfies state nonforfeiture laws, guaranteeing that the owner always has a minimum-protected cash value, and (3) the product is either sold in a state that has adopted suitability standards that are modeled after those of the NAIC, or the insurer is domiciled in a state that has adopted the Model or the insurer itself adopts the suitability standards on its own, subject to exam oversight. To date, 37 states (plus the District of Columbia) have adopted the Suitability model regulation, and insurance companies that operate on a nationwide basis have adopted suitability standards that meet or exceed the model regulation. Accordingly, fixed indexed annuities are regulated and treated exclusively as insurance products and not securities in all states.

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- Fixed indexed annuities comply with standard non-forfeiture laws, which includes minimum guaranteed values, whereas variable annuities are unlimited as to risk of loss.

- With all fixed indexed annuity contracts the insurance company retains the market risk, the contract owner receives interest at a rate based on the referenced index's performance and interest is paid from the company's general account funds.

The chart below demonstrates that fixed "declared rate" annuities and fixed "indexed rate" annuities share the same fundamental features and regulatory oversight, and that variable annuities differ dramatically from both of them.

ANNUITY COMPARISON CHART			
	Fixed Annuity	Fixed Indexed Annuity	Variable Annuity
Predictable income stream	X	X	
Principal & credited interest guaranteed[8]	X	X	
No downside market risk	X	X	
Subject to state non-forfeiture laws	X	X	
Regulated as insurance product	X	X	X
Regulated as a security			X
Individual's premiums and interest held in the insurer's general account	X	X	
Individual's investment funds held in separate account			X
Actual gains and losses based on the market performance of the subaccounts			X
Provides substantially predictable income that is contractually guaranteed	X	X	

[8] Subject to surrender charge, but guaranteed at a minimum SNFL value.

II. The state regulatory system has a process that provides insurance product purchasers with the ability to resolve complaints

Insurance product purchasers have two options to pursue when trying to resolve a complaint or grievance. First, the consumer can reach out directly to the insurance company that sold the product. Upon receipt of the complaint, the insurance company must address the issue within a specific timeframe under the laws of most states and engage in good faith discussions. The insurance company must also comply with applicable regulatory requirements regarding documentation and retention periods.

Insurance product purchasers also have the option to contact their state department of insurance (DOI) rather than the issuing insurance company to lodge a complaint. Under this option the DOI will serve as a conduit/mediator regarding the grievance and proposed resolution.

As part of the regulatory oversight structure, DOIs typically include complaints as a topic area when performing a market conduct examination of a life insurance company. Moreover, the DOI for the state where an insurance company is domiciled will perform a detailed check of the compliance structure and complaint administration process when performing comprehensive periodic reviews.

For the most part, however, we rarely get to dispute resolution. In 2014 consumer complaints involving securities and advisors represented over 97% of combined annuity and securities complaints – but only .03% of total complaints were lodged by owners of fixed annuities.[9]

III. The investment education carve-out must distinguish educational activity from investment advice

During the August public hearings on the proposed rule, Deputy Assistant Secretary Hauser asked when we might consider that an advisor's or broker's communications with potential clients "trips" the fiduciary line. NAFA believes that this is the

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[9] Data Sources: FINRA: http://www.finra.org/newsroom/statistics; NAIC: https://eapps.naic.org/documents/cis_aggregate_complaints_by_coverage_types.pdf; SEC: http://www.sec.gov/news/data.htm; NASAA: http://www.nasaa.org/regulatory-activity/enforcement-legal-activity/enforcement-statistics/ (2013 data only).

essential question in framing the argument for a clear and meaningful non-fiduciary investment education carve-out. It is critical that insurance agents are allowed to provide in-depth education regarding particular fixed annuity product features so that retirement consumers can make sound and informed retirement decisions.

The role of the insurance agent is to educate the consumer and to make a recommendation based upon the consumer's individual financial needs and goals

The role of the insurance agent in selling fixed annuities and fixed indexed annuities is focused on education: educating the consumer about the various features that the annuity offers to grow and protect retirement assets and income, and, more importantly, educating the insurance agent about the individual consumer's personal financial situation and needs.

A fair amount of discussion during the Department's August public hearing centered on the role of education in the sales transaction to purchase various retirement vehicles, including annuities. Assistant Deputy Hauser made the following comment regarding the role of the advisor in understanding the financial needs of the individual consumer:

> So say that the person on the other end of the phone or in the office is talking to, you know, a 75 year old about how to invest their money and they say, everybody at your age should invest in such and such product, that's it. There's no – **they haven't looked into their circumstances, they haven't done any individualized analysis, but they've quite clearly made a specific recommendation.** Should that really not be treating, treated as fiduciary while we would treat as fiduciary a communication where the broker or the advisor at least made the minimum effort of understanding what the customer needed?[10]

In stark contrast to the hypothetical advisor in this scenario, before making any recommendation, the insurance agent who transacts fixed annuity business is required to fully understand the individual's financial needs and objectives, considering at a minimum[11] the following information pertaining to the prospective client before providing any advice regarding the purchase of an annuity:

[10] Transcript of Dept. of Labor Public Hearing, August 10, 2015, pp. 136 – 137 (emphasis added).

[11] Some states, and some insurance companies, require this review to include information in addition to the twelve points listed here. See e.g., Minnesota Stat. §72A.2013, which adds to this inquiry whether or not the consumer has a reverse mortgage, *available at* https://www.revisor.mn.gov/statutes/?id=72A.2031.

1. Age
2. Annual income
3. Financial situation and needs, including the source of the funds used to purchase the annuity
4. Financial experience
5. Financial objectives
6. Intended use of the annuity
7. Financial time horizon
8. Existing assets, including investment and life insurance holdings
9. Liquidity needs
10. Liquid net worth
11. Risk tolerance
12. Tax status

In addition to this suitability review, insurance agents, who are licensed and regulated under state insurance laws, ensure that the consumer has been informed of and understands of the various features of the annuity, such as any potential surrender charge period and surrender charges; potential tax penalties; limitation on interest returns; and features of and charges for riders, such as death benefits, etc.

In the case of fixed annuity or a fixed index annuity sales transaction, it just isn't the case that the advisor or agent makes a recommendation without first undertaking individual analysis to understand what the customer needs.

However, as the proposed rule is currently drafted, it is unclear whether fiduciary obligations would be triggered at the first instance an insurance agent provides educational or marketing material about a particular fixed annuity product. NAFA is also concerned that merely discussing distributions and rollovers with a prospective client would be considered investment advice, thereby triggering the fiduciary standard.

Additional clarity on what would be considered non-fiduciary communications under the proposed rule's investment education carve-out under Section 2510.3-21(b)(6) is needed; the guidance should incorporate the language provided in the Department's Interpretive Bulletin 96-1.

IV. Streamlined Exemption for Annuities that Only Pay Trail Commission

The Department has asked whether certain investment products may pose so little risk that conflicts are driving the recommendation that a simple streamlined exemption should be created to promote such products. We suggest that a class of fixed annuity products meet this criteria and the public policy goals the Department is pursuing. Specifically, a deferred fixed annuity contract with a surrender charge period of no more than seven years and a commission structure that pays trail only to the insurance agent is that product. Such an annuity product addresses the policy goals of the Department in that it –

- Pays interest at a contractually mandated rate and is not subject to market risk throughout the deferral period, i.e. risk free growth of principal;
- Has a maximum surrender charge period of seven years which promotes the long term nature of retirement savings, shielding these savings from the demands of day to day expense, but still provides the flexibility to periodically reallocate the funds to other retirement savings vehicles if needs and goals should change;
- Through required annuitization provisions and optional guaranteed withdrawal benefit riders, is the only retirement savings vehicle that provides a stream of periodic payments over the life of the owner, i.e. a personal pension;
- Is time tested over a long history of various financial conditions/challenges to provide safety and security of principal and performance of lifetime payments due to a regulatory structure that ensures the long term risk nature of the industry is properly addressed; and
- Is subject to a comprehensive regulatory structure that ensures consumer interests are met as financial markets change and evolve and that grievances of individual consumers are properly addressed.

Moreover, by restricting the commission structure to trail payments only, the product mitigates any potential conflict for the insurance agent in two important respects. First, the trail payment, which is an annual amount paid based on the value of the annuity, is very much akin to the fee a consumer would pay to a fee-only advisor. Second, the maximum surrender charge structure of seven years would limit the amount of trail commission that could be paid to a reasonable rate.

In our humble opinion, the product described above should be part of every American's retirement savings portfolio. This product is unique among the entire spectrum of retirement savings vehicles in addressing the Department's policy goals in a complete and comprehensive manner. A streamlined exemption facilitating the ease of sale is entirely appropriate.

CONCLUSION

Unlike security products such as mutual funds, stocks and bonds, or variable annuities where the consumer can lose money, with a fixed annuity – including of course fixed indexed annuities – there is no downside risk for the client's principal and credited interest – even when the market goes down. Security products simply do not have the guarantees that fixed annuities have.

Indeed, fixed annuities are unique among all investment and financial planning vehicles in that they offer a combination of benefits and guarantees to help consumers achieve their long-term retirement goals. The two most critical guarantees in this regard are the guaranty that the annuity will accrue *at least* the minimum interest rate credited to the contract during the accumulation phase and that there is a guaranteed minimum income payout during the distribution phase.

With fixed annuities, the client knows exactly what their account is worth – every day, week, and month. They know what the minimum account value will be one year from now, three years from now, ten years from now: those values are guaranteed under the contract from the insurance company. And with fixed indexed annuities (unlike all securities products), the investment risk is shifted to the insurance company.

The features and benefits of fixed annuities make them unlike any other retirement planning product. NAFA believes that fixed annuities are the best products to safely fund or augment most Americans' retirement needs. The insurance-backed guarantees, the fact that there is no risk to the client's principal, and the guaranteed income options are very good solutions to today's retirement crisis.

For these reasons, the Department's inclusion of all non-security fixed annuity products under PTE 84-24 was correct in the proposed rule and should remain that way under the final rule.

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Again, on behalf of NAFA and its members, I want to thank you for the opportunity to submit these additional comments. Please do not hesitate to contact me if you would like additional information or if you have any questions.

Sincerely,

Chip Anderson

Charles "Chip" Anderson
NAFA Executive Director