The COMMITTEE of ANNUITY INSURERS

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Office of Exemption Determinations
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Re: *Definition of the Term Fiduciary; Conflict of Interest Rule (RIN 1210-AB32)*
Proposed Amendment to Proposed Partial Revocation of Prohibited Transaction Exemption 84-24 (ZRIN: 1210-ZA25)
Proposed Best Interest Contract Exemption (ZRIN 1210-ZA25)

We are writing on behalf of the Committee of Annuity Insurers (the "Committee") to comment on the proposed regulation published by the Department of Labor (the "Department") that redefines the circumstances in which a person is considered an investment-adviser fiduciary under the Employee Retirement Income Security Act of 1974 ("ERISA") and section 4975 of the Internal Revenue Code of 1986 ("Code"). The Committee is a coalition of life insurance companies formed in 1982 to participate in the development of federal policy with respect to annuities. The Committee's current 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. This letter provides comments on the proposed regulation and the proposed exemptions (new and revised) that are relevant to annuities, particularly the Prohibited Transaction Exemption ("PTE") 84-24 and the Best Interest Contract Exemption ("BICE").

INTRODUCTION AND SUMMARY OF RECOMMENDATIONS

President Obama's Administration has made great strides to elevate a critical issue for the retirement security of Americans – enhancing access to and understanding of lifetime income options like annuities. The Department of the Treasury and the Department of Labor have both recognized that as workers and savers increasingly find their retirement savings in the form of 401(k) plans, 403(b) plans, and IRAs, it is critical that we facilitate better access to, and more use of, arrangements designed to provide a stream of income that is guaranteed to continue as long as an individual lives.[1] The Committee shares these goals and is deeply appreciative of the Administration's efforts. The member companies of the Committee fully support a regulatory regime that requires financial professionals who provide investment advice to act in the best interest of their clients. Nevertheless, it would be a disservice to both Americans preparing for retirement and those already retired if we did not clearly express the Committee's belief that the Department's current proposal will seriously undermine the Administration's goal of advancing the availability and use of lifetime income products and strategies.

As described below, the proposal makes it harder, not easier, to help individuals understand how and when an annuity might be appropriate for their retirement planning. The proposal potentially turns any conversation about an annuity used to accumulate or distribute plan or IRA[2] retirement benefits into a fiduciary discussion. Further, because the Department has proposed to curtail the availability of PTE 84-24 and because the costs and risks associated with the BICE make the BICE uneconomical to use except for the wealthiest clients, we are very concerned that there will *be reduced access to and use of guaranteed income for life* for those who most need it. Our comments are offered with the goal of avoiding these very unfortunate and unintended consequences.

Our key recommendations are as follows:

- The Department should fully consider the costs of its rulemaking and the potential consequences thereof and proceed with appropriate regulatory coordination.
- Unless the Department expands the seller's carve-out, the regulation will severely limit access to and use of annuities and other lifetime income products in retirement plans and IRAs. Thus it is critical that the Department provide that ordinary sales activities with plans (of all sizes) and IRA owners do not trigger fiduciary status in situations where there is no expectation that impartial advice is being provided.
- 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.
- The Department should clarify certain aspects of the fiduciary status test to avoid sweeping in non-fiduciary communications.

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[1] *See e.g.*, Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans, 75 Fed. Reg. 5253 (Feb. 2, 2010) (seeking input on steps that could be taken to facilitate "access to, and use of, lifetime income or other arrangements designed to provide a stream of lifetime income after retirement" in light of "the continuing trend away from traditional defined benefit plans to 401(k) defined contribution plans …" under which employees are increasingly responsible "for ensuring that their savings last throughout their retirement years and, in many cases, the remaining lifetimes of their spouses and dependents").

[2] In this letter, we often refer to "IRAs." Unless otherwise noted, we mean both individual retirement accounts described in section 408(a) of the Code and individual retirement annuities described in section 408(b) of the Code. Some annuities are held within an IRA account and some are held as an IRA annuity. In fact, one key concern we have is that the Department has not recognized in the proposal the importance individual retirement annuities play in the retirement security of American savers.

- The proposal should not cover advice about distributions that does not involve an investment recommendation.
- The proposal should be modified to preserve valuable education for IRA owners and plan participants.
- The platform carve-out should be amended and clarified to ensure it works as the Department intends.
- The Department should clarify that ordinary annuity valuations are not fiduciary investment advice.
- The Department should clarify that current law advice programs are still available.
- PTE 84-24 should be the model for the Department's "principles-based" exemption, because the Committee has significant concerns about whether the BICE is workable.
- An additional "low-fee" exemption is inappropriate without significant additional public input through a separate regulatory process.
- The Department should provide a transition period of at least three years and fully grandfather all communications related to annuities that have previously been issued.

I. The unique nature and function of annuities in providing retirement security.

A. The insurance protections annuities provide.

Retirement presents many financial risks for Americans. Prior to retirement, an individual must attempt to accumulate adequate savings. During retirement, an individual must draw down those savings over life without exhausting those savings prematurely. Annuity contracts in their various forms are uniquely suited to help meet both these goals because they can both facilitate retirement savings and guarantee income for as long as a retiree lives.

During the savings or "accumulation" phase of retirement, individuals must determine how much they need to save over time in order to have a sufficient amount to live on for up to two or three decades in retirement. Critical to that effort is the long-term rate of return the individual is able to achieve on his or her savings. If the rate of return is insufficient to keep pace with inflation, the purchasing power of an individual's savings will be eroded over time, putting retirement security in real jeopardy. On the other hand, investments in equity securities or similar assets that can bring higher returns to help address inflation risk also bring with them exposure to market volatility and risk of loss.

Deferred annuities in their various forms can help address both these risks while simultaneously guaranteeing an employee or IRA owner the right to convert – at a guaranteed rate – the savings accumulated under the annuity into a stream of lifetime income. This is because a "deferred annuity" has two phases that correspond to the two phases of retirement planning just described – an accumulation phase and a distribution phase. During the accumulation phase, the owner contributes savings to the annuity contract and those savings grow with interest or earnings to generate an account value (often referred to as the "cash value" or the "cash surrender value"). During the distribution phase, the owner can apply the account value to one of several payout options offered under the contract at rates guaranteed from the inception of the contract, such as monthly payments guaranteed to continue for at least the owner's life. The longer that the contract is in the "accumulation" phase, the more valuable these guaranteed payout rates may become, because the guaranteed rates are based on mortality tables in effect at the time that the contract is issued and not the reduced payout rates that would result from subsequent increases in longevity.

Accumulating retirement savings is only one half of the retirement security equation. The other half is making those savings last throughout a retirement period of unknowable duration. Converting retirement savings into a sustainable stream of retirement income can be a daunting task for an individual to undertake without the right tools. In addition to uncertainty about future personal expenses, inflation, and asset returns, it is impossible for an individual to predict how long he or she will live and therefore how long his or her savings will need to last.[3] As a general matter, individuals are living longer and spending more time in retirement than ever before, which could leave too many Americans with little or no income in the later years of retirement. This risk of guessing wrong about how long savings will need to last – longevity risk – is a risk that every retiree faces. And with 77 million baby boomers beginning to enter retirement, the societal need to help individuals address that risk is escalating.

Annuities, again, offer an extremely valuable solution. 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.[4] This type of insurance guarantee is becoming increasingly important in light of factors such as reduced coverage by employer-sponsored defined benefit plans and the limited availability of annuity options in defined contribution plans.[5]

Absent guaranteed lifetime retirement income from an annuity, many Americans may run out of savings or face very difficult circumstances. On the other hand, retirees who receive guaranteed lifetime income from annuities are more likely to have an adequate standard of living, even if they live into their 90s or beyond; live more independently (and avoid becoming a burden on others, *i.e.* relatives and the government); and have the peace of mind that guaranteed lifetime income can bring.

Annuities, both those that are securities and those that are not, provide insurance protection against longevity risk by pooling that risk among a large group of individuals, so that no single individual bears the burden of the entire risk alone. Guaranteed lifetime income from an annuity is available in a variety of forms that can be tailored to meet the individual's specific needs, including traditional fixed life contingent annuity payments, life contingent variable

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[3] Americans typically substantially underestimate their life expectancy. This, of course, can lead to inadequate savings, but also multiplies the risks of spending savings too rapidly (or too slowly) upon retiring. *See* SOCIETY OF ACTUARIES, 2011 RISKS AND PROCESS OF RETIREMENT SURVEY REPORT 9 (March 2012) (survey demonstrates that more than half of retirees and pre-retirees underestimate "how long the average person their age and sex can expect to live") *available at* https://www.soa.org/files/research/projects/research-2011-risks-process-report.pdf.

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

[5] *See infra* note 24.

annuity payments, and guaranteed lifetime withdrawal benefits. In addition, the benefits of lifetime income can be obtained either by converting the savings accumulated in a deferred annuity to a stream of lifetime payments or by purchasing an immediate annuity or longevity insurance with savings accumulated elsewhere. An immediate annuity has no accumulation phase and thus can facilitate the conversion of other sources of retirement savings into retirement income that begins at (or shortly after) the time the contract is purchased. Longevity insurance (sometime referred to as a deferred income annuity) provides yet another important way to receive guaranteed lifetime income by allowing an individual to purchase a dollar amount of lifetime income that will begin at a later age, *e.g.*, a purchase at age 65 of $500 of monthly income beginning at age 85.

Annuities often combine insurance against longevity risk with other "living benefits" that protect against additional financial risks that retirees face, including investment risk and inflation risk. In all their various forms, however, the key feature of annuities is that they mitigate the longevity risk individuals face because they provide a retirement income stream that is guaranteed to continue for life. Life insurance companies are the only entities that can provide this protection other than defined benefit plans and the government itself.

B. The nature and cost of annuity guarantees.

As described above, annuities provide a variety of guarantees that are critical to individuals assuring themselves a secure retirement. The guarantees can cover multiple risks, including longevity risk (the risk that an individual will outlive her assets), mortality risk (the risk that an individual will die before, *e.g.*, she receives payments from her annuity equal to the amount paid for it), investment risk (the risk that an individual's assets will fail to grow at an expected rate or will lose value), and expense risk (the risk that the expenses associated with an the annuity will exceed specified maximums). These risks are typically of a long-duration. For example, in the case of a deferred fixed or variable annuity, the insurer is guaranteeing from the time the contract is purchased that the owner will always have the right 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. Thus, for example, if Jill Smith purchases a deferred IRA annuity at age 50, she will have the right for however long she lives to turn the amounts she invests and the earnings on those amounts into a life annuity.

When a life insurance company issues an annuity contract, the employee, IRA owner, or retiree is shifting the risks covered by the annuity guarantees from herself and her family to the insurance company.[6] These guarantees provide financial (and often emotional) security to workers and retirees, but in making the guarantee the insurance company has assumed risks for which it must be compensated to assure it can provide the benefits promised. In simple terms, premiums and other charges plus the investment returns on retained funds must be adequate to

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[6] The insurance company pools the risks it assumes from its policyholders and then distributes them among the policyholders. Since no individual knows how long she will live, the annuity pool allows individuals to protect themselves from longevity risk without having to accumulate retirement savings that will carry them through to the latest possible date to which they might live. *See, e.g.*, KENNETH BLACK, JR. ET AL., LIFE INSURANCE 38 (14th ed. 2013).

fund the current and future benefits that the insurance company promises under the annuity, as well as related expenses, taxes, contingencies and profits.[7] (Increasingly, the product must be priced to take into account the costs associated with compliance and the risk of litigation.) In other words, annuity products must be designed and priced so that the insurer can satisfy the guarantees for many years into the future.

The risks assumed by insurance companies with respect to the annuities they issue are substantial. At the end of 2013, the reserve liabilities of U.S. life insurance companies with respect to annuity contracts issued in connection with tax-qualified retirement plans and IRAs were in excess of $1.5 trillion.[8] Reserves assure that the contractual commitments insurers make to their annuity policyholders will be paid. In substance, these reserve liabilities represent the dollar value of the protections provided to retirement savers and retirees through qualified annuities, including IRA annuities, at year end 2013.[9]

Annuity reserves must be funded in a manner prescribed by the insurance laws and regulations of the states. These funds come from the premiums paid by individuals and their employers, the periodic charges assessed by insurance companies under the terms of the annuity contracts, and the investment return insurers receive on those premiums and charges. In simple terms, if insurance companies are to provide protections against longevity and similar risks faced by Americans in connection with retirement, they must charge those savers for doing so. As the authors of the standard textbook on annuities and life insurance contracts observe in the most recent edition of their text:

> [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 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.
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> 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]

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[7] *Id.* at 378.

[8] AMERICAN COUNCIL OF LIFE INSURERS, 2014 LIFE INSURERS FACT BOOK 75 (Table 8.2 Group Annuities); BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FEDERAL RESERVE STATISTICAL RELEASE Z.1, FINANCIAL ACCOUNTS OF THE UNITED STATES, FIRST QUARTER 2015 127 (IRAs held by life insurance companies).

[9] *See, e.g.*, Black *supra* note 6, at 298. ("A life insurer's most important source of financing is premium income, and its most prominent liability is the policy reserve, which represents a segregation and dedication of premium and investment income to the payment of future claims. Reserves represent the net of the expected present value of future benefits and future premiums, both using interest and mortality assumptions defined in the applicable valuation statute.").

[10] *Id.* at 602-603.

As noted above, the premiums and other charges for annuities, plus the investment returns on retained assets, must also fund expenses, taxes, and contingencies related to the contracts, as well as a return on the insurer's capital. The expenses incurred by an insurer in connection with any insurance product, including annuities, include the costs of distributing or selling the product to those who would benefit from the insurance protections provided. These distribution costs include the compensation paid to those who sell the insurance product. One element of the compensation that must be paid to individuals selling an insurance product is for the time and effort they must invest in (1) developing an understanding of the particular products they offer to consumers, and (2) gaining an understanding of the needs of the particular consumer they are interacting with so they can assure an appropriate match between the needs of the consumer and the features of the insurance product.

Although not all annuity contracts are complex, many are. *The complexity is driven by insurers' attempts to meet consumer need to provide insured retirement income*. The academic literature and the annuity market place both recognize that individual consumers often are hesitant to purchase the simpler forms of annuity contracts.[11] For example, many consumers understandably desire the protections a life annuity provides, but also want the liquidity provided by other investments. Guaranteed lifetime withdrawal benefits ("GLWBs") are one response to this need.[12] While the benefits of a GLWB to a consumer are valuable, an insurance agent must invest significant amounts of time in learning how the benefits work and then explaining those benefits, risks, and costs to a potential policyholder. Similarly, many consumers desire the protection of a guaranteed investment return with the possibility of turning their investment and the return into a life annuity, but also want some of the potential upside of the equity markets. Fixed indexed annuities can provide this combination of benefits through the insurer's guarantees. Here, too, it is of course incumbent on the individual who is selling the product to understand the contract and be able to explain the advantages and disadvantages of the contract to potential purchasers.[13] Not surprisingly, given the complexity and risk/reward tradeoffs, not

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[11] There has been considerable academic research on this point. A good summary of the literature can be found in John Beshaears et al., *What Makes Annuitization More Appealing?*, Journal of Public Economics (last revised May 11, 2013) *available at:* http://www.hks.harvard.edu/fs/bmadria/Documents/Madrian%20Papers/What%20Makes%20Annuitization%20More%20Appealing.pdf.

[12] One study exploring the reasons more individuals do not annuitize has specifically pointed to GLWBs as a product development that appears to overcome consumer resistance to annuitization. *See* Jeffrey Brown et al., *Why Don't People Choose Annuities? A Framing Explanation*, The Retirement Security Project, at 2 (March 2008) (noting the "recent relative popularity of variable annuities offering 'guaranteed minimum withdrawal benefits for life,' perhaps because these products successfully blend some features of a life annuity with some features of a more traditional investment product") *available at*: http://www.brookings.edu/~/media/Projects/retirementsecurity/03_choosing_annuities.PDF.

[13] Under the National Association of Insurance Commissioners ("NAIC") Suitability in Annuity Transactions Model Regulation (Model 275), which has been adopted by most states, there are express training obligations imposed on insurers and insurance producers with respect to annuity products. These training obligations are intended to ensure that licensed insurance producers understand annuity products generally, and also understand the annuity products issued by a specific insurer. In that regard, Section 7 of Model 275 includes a requirement that a licensed producer is required to complete a training course on annuities, approved by the state insurance department, that focuses on, among other things: the types of annuity contracts; the parties to an annuity contract; how fixed, variable and indexed annuity contract provisions affect purchasers; and appropriate sales

every retirement investor decides to purchase an annuity. This is appropriate but in turn requires a compensation arrangement (*i.e.*, up-front commissions) that recognizes a significant time commitment with an uncertain outcome.

Given these considerations, it is understandable and appropriate that the "cost" of an annuity contract can in many instances be materially greater than the "cost" to an employee or IRA owner of purchasing an index fund. An individual who purchases an annuity contract is obtaining multiple guarantees, with the particulars of those guarantees depending on the specific type of contract purchased. The insurance company must charge an appropriate premium to assure that it can pay the benefits it has promised, which can have a long duration and often require complex investment strategies. Likewise, it must compensate the sales agent for the time, effort, knowledge, and experience that the agent brings to the sale. We would also point out that a one-time upfront commission with a small trailer will often be substantially less compensation to the adviser than they would earn from an ongoing advisory fee when holding periods are long, which is often the case with annuities.

The Committee recognizes that there have been instances in which individuals purchase an annuity with their retirement savings when they would have been better advised to diversify their retirement savings, to purchase a different type of annuity, or not have bought an annuity at all. The annuity industry, in combination with state insurance regulators and self-regulatory organizations like the Financial Industry Regulatory Authority ("FINRA"),[14] have taken

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practices, replacements and disclosure requirements. In addition, Section 6(F)(1)(c) of Model 275 requires that the insurer's supervisory system also includes product-specific training that explains all the material features of its annuity products to its licensed insurance producers. Many states have also adopted the NAIC's Annuity Disclosure Model Regulation (Model 245) that 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 the annuities being offered are variable annuities sold through a broker-dealer, FINRA imposes ongoing continuing education requirements that must be satisfied by the registered individual, delivered both through FINRA (the "regulatory element") and through the firm itself (the "firm element").

[14] Starting in 1996, FINRA has provided specific guidance and taken other regulatory action with respect to the application of its suitability rules to variable annuity sales. In May 2008, a targeted variable annuity suitability rule – FINRA Rule 2330 – became effective. That rule creates heightened suitability obligations, expanded principal review and approval requirements, and supervisory and training requirements with respect to deferred variable annuity transactions. While the rule makes exception for certain transactions involving employer-sponsored retirement or benefit plans, it applies in full force to recommendations made to individual qualified plan participants and recommendations in the context of IRAs. Recent remarks from FINRA officials suggest that the FINRA exam staff has seen improved controls around variable annuity sales practices since the adoption of Rule 2330. *See* Remarks of Richard G. Ketchum, Chairman and CEO, FINRA at IRI Government, Legal, and Regulatory Conference (June 28, 2011) *available at*: https://www.finra.org/newsroom/speeches/062811-remarks-iri-government-legal-and-regulatory-conference.

In 2003, the NAIC adopted the Senior Protection in Annuity Transactions Model Regulation. The Regulation originally applied to recommendations to individuals who are sixty-five years old and older on transactions involving annuity products. In March 2006, the regulation was expanded to all individuals, not just those over the age of sixty-five and was renamed the NAIC Suitability in Annuity Transactions Model Regulation. The expanded Model Regulation was further revised and updated in 2010, with the changes closely modeled on FINRA Rule 2330 and adding a training requirement. The Model Regulation applies to recommendations of all immediate and deferred fixed and variable annuity contracts used to fund IRAs, including recommendations of all immediate and deferred fixed and variable annuity contracts made in connection with rollovers to IRAs. (It does not numerous steps over the years to better assure that an annuity purchase matches the needs and the interests of the purchaser.[15] These efforts have produced positive results and will continue.

It is critical that the Department's efforts to assure that America's retirement investors receive the protections they need and deserve – and that are required by ERISA and the Code – do not result in reduced access to and use of guaranteed income for life for those who most need it. Our comments in the remainder of this letter are offered with the goal of avoiding these unfortunate and unintended consequences.[16]

II. The Department should fully consider the costs of its rulemaking and the potential consequences thereof and proceed with appropriate regulatory coordination.

The proposed regulation is inarguably the Department's most sweeping rulemaking in a generation. In the limited time since the proposal's many pieces were released in April, the life insurance industry has just begun to understand the proposal's implications. The definition of an investment-adviser fiduciary is foundational to both ERISA and the prohibited transaction rules of the Code. It determines the extent to which a person providing investment-related services is subject to fiduciary standards of conduct under ERISA and the extent to which the prohibited transaction rules are potentially applicable. Existing practices associated with the sale and distribution of annuities have developed in light of the current regulation, and any changes will have potentially far sweeping consequences for interested stakeholders.

The threat of personal fiduciary liability will chill valuable education. Like others, the Committee supports rules ensuring that those who provide investment advice act in their clients' best interest. But the Department must also understand that *fiduciary status* comes at great expense. It increases the cost of providing the product or service and creates the risk of expensive litigation, which takes years and millions of dollars to win even when frivolously brought. This is particularly true if the standard comes encumbered with numerous additional requirements that cast doubt on whether commission-based sales are permitted at all, as is the case with the Department's new proposal. In addition to the costs on organizations, ERISA

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apply to transactions involving contracts used to fund plans covered by ERISA and plans described by sections 401(a), 401(k), 403(b), 408(k) or 408(p) of the Code.)

[15] Insurers and/or their distributors perform the required suitability analysis before issuing a contract. Contracts that are deemed unsuitable for the potential customer are declined. One Committee member provided the following example: In 2014, 12,095 transactions were subject to the insurer's suitability review process. Of those transactions, 4,804 passed initial suitability review and 83 (1.7%) were declined on the basis of suitability. The remaining 7,291 transactions were subject to an enhanced suitability review. Of those, 201 (2.8%) were declined on the basis of suitability. These actions serve to weed out unsuitable annuity sales, which are outliers. Under the NAIC model suitability regulation, described *supra* note 13, as adopted by most states, the insurer is responsible for the suitability of its products for the consumer, regardless of whether the actual suitability review and evaluation is done by the insurer or is delegated to a third party. Even if that function is delegated, the insurer is required to monitor the sales activity of the third party distributor for any red flags indicating sales practice/suitability issues and provide reports to the third party with its findings.

[16] Appendix A describes in more detail the various forms of annuities and their benefits, including the relationship between the guarantees provided by an annuity and the costs of these guarantees.

threatens *personal* liability on individuals, which is rarely presented anywhere else in the business world.[17] Thus, under the proposal, every call center employee for an insurance company who speaks with a customer is continuously subject to the possibility of personal fiduciary liability for every single conversation. Retirement savers will bear the significant costs of imposing fiduciary duty where it does not belong.

Substantive changes to the proposal are necessary. The Department's stated goal for the 2010 proposal was to close loopholes in the current regulation that frustrated enforcement by the Department; for example by allowing persons who represented that they were providing impartial fiduciary advice to escape fiduciary status because the advice covered only a single transaction. While the Committee supports closing inappropriate loopholes, we believe that the proposed regulation and exemptions do not strike the correct balance. Accordingly, we believe substantial changes to the proposed regulation and exemptions are necessary and we fully expect the Department will receive significant comments. We strongly urge the Department not to rush this project to completion before thoughtfully considering the comments.[18]

Substantial time will be needed for insurers and others to implement the new rules. It is self-evident from the materials the Department released that Department staff has worked very hard on the reproposal. We know the Department wants to get this right and would want future Administrations to support the results of the final rule. For that reason, the Department needs to proceed carefully and fully consider all the comments it receives. Further, as we explain in more detail below, because the proposal will affect nearly every interaction an insurance company and its employees, agents, and brokers have with nearly every plan and IRA owner, an immediate effective date, with an eight month "applicability" date, is simply not workable. We recommend that the proposal not be effective for at least three years after publication of a final rule.[19]

Exclusion for annuity contracts previously purchased. We also strongly urge the Department to provide that the proposal will not apply to annuities purchased and arrangements entered into prior to the effective date of the regulation. Simply to continue to interact with existing customers after the regulation is in place means significant new costs. These new costs have not been priced into products sold before the Department issued the final regulation. This is particularly disruptive for annuities, because annuities are long term commitments from an insurance company priced with certain assumptions about the obligations of the insurer.

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[17] *See* ERISA § 409.

[18] While the Department, of course, put many years of thought into this reproposal, the reproposal is substantially different from the 2010 proposal. Therefore, appropriate consideration must be put into addressing the comments on the reproposal.

[19] If the Department elects not to provide an effective date and implementation period of at least three years, and demonstrates a compelling public policy need consistent with applicable administrative procedure requirements for a shorter effective date, then we urge the Department to consider a phased implementation, for example providing more time to put procedures in place to satisfy the complex conditions of the various prohibited transaction exemptions.

Further coordination with the SEC and FINRA is needed. In addition, the Committee urges the Department to further consult with the staff of the Securities and Exchange Commission ("SEC") and FINRA to ensure that the proposal does not subject investment advisers and broker-dealers to requirements that create undue compliance burdens and conflicts with their obligations under these other laws and rules. In this regard, we note that during the Committee's review of the proposal, we have identified a number of inconsistencies and conflicts between the proposal and the applicable federal securities law framework. By way of example:

- The BICE would require a financial institution to enter into a written agreement before any recommendation may be made. In contrast, the federal securities laws do not require that a broker-dealer or adviser enter into a written agreement and where such entities do enter into agreements, the timing of the execution is flexible.

- The BICE would require a chart prior to sale in which the adviser is directed to make "reasonable assumptions" about the future investment performance of an amount proposed to be invested. The proposed chart is contrary to the communications required or permitted by the federal securities laws and relevant rules. For example, the SEC requires mutual fund and variable prospectuses to set forth a "Fee Table," which is required to be standardized – based upon a $10,000 investment—and calculated on a 5% return. FINRA rules regarding communications with the public prohibit projections of future investment performance. The advertising rules set forth under the Investment Advisers Act of 1940 ("Advisers Act") prohibit projections of investment returns.

- Finally, as discussed below, the BICE requires an affirmative statement that the Financial Institution and Adviser are fiduciaries with respect to recommendations. This affirmative statement causes questions as to whether broker-dealers and their registered representatives, who affirmatively state they are fiduciaries, may rely on the broker-dealer exception in the Advisers Act. If the SEC were to determine that the broker-dealer exception is not available under such circumstances, there would be formidable business, compliance, and legal complexities attendant with registering these firms and individuals as advisers and investment adviser representatives.

As noted, we offer the above as examples. There are a number of other instances where further coordination with staff of the SEC and FINRA is critical.

III. <u>The Need for a Workable Seller's Carve-Out.</u>

A. Introduction.

The underpinning of the entire proposal is that any communication that would reasonably be viewed as a "suggestion" that a person engage in or refrain from taking a particular course of action, if that suggestion is individualized or directed at the recipient for consideration, potentially triggers ERISA fiduciary status, the highest duty known to law. The Department has cast this wide net, apparently, on guidance from FINRA.[20] We question whether the FINRA standard makes sense here. That standard has been developed to determine which communications fall within the scope of FINRA's suitability rule. Even if the Department decides to use the FINRA standard, we believe that it is not being applied consistently with FINRA's rules. In this regard, we note that communications that fall short of a "call to action" are not deemed to be recommendations under FINRA's suitability rules. We also note that FINRA's suitability rule excludes general financial and investment information, descriptive information about an employer-sponsored retirement or benefit plan, and certain asset allocation models to the extent that they do not include a recommendation of a particular security or securities.

Because the Department's net is so wide, it is critical, as the Department recognizes, that the proposal "appropriately distinguishes incidental advice as part of an arm's length transaction with no expectation of trust or acting in the customer's best interest, from those instances of advice where customers may be expecting unbiased investment advice that is in their best interest."[21] However, the proposal currently limits this "seller's carve-out" to discussions with fiduciaries of large plans. We strongly recommend that the seller's carve-out not be limited to fiduciaries of large plans, but rather should be available in appropriate circumstances for discussions with all plan fiduciaries, participants, and IRA owners.

We understand that discussions with a plan fiduciary, participant or IRA owner in the context of the sale of an annuity should not be presented as unbiased advice. For that reason, the conditions that the Department attached to the seller's carve-out in this proposal and in the 2010 proposal would be appropriate to ensure that selling is not misrepresented. For example under the new proposal, in the context of persons who are fiduciaries of plans with 100 or more participants, a counterparty (a) must obtain a written representation that the person will not rely on the counterparty to act in the plan's best interest, provide impartial investment advice, or give advice in a fiduciary capacity; (b) must inform the person of the existence and nature of the counterparty's financial interests; (c) cannot receive a fee for the provision of investment advice; and (d) must receive a written representation that the person has sufficient expertise to evaluate the transaction and to determine whether the transaction is prudent. *If those conditions are satisfied, whether the person is a plan fiduciary, participant, or IRA owner, it is hard to see how in any sense the person would be confused that they are expecting unbiased investment advice.* Thus we would be supportive if similar conditions were imposed on a seller's carve-out expanded to small plans and IRAs.

An example of a situation – but by no means the only situation – in which a person would not be confused or expecting unbiased investment advice is a direct sale of a product. Many insurance companies distribute their products directly, and the salesperson is a common law or statutory employee of a single insurance company. In such a case, the financial interest of the company is obvious, and there cannot be any confusion about the existence of that financial interest. The research cited by the Department does not call into question the self-evident point

[20] *See* 80 Fed. Reg. 21,928, 21,938 (April 20, 2015) (citing FINRA Policy Statement 01-23).

[21] 80 Fed. Reg. at 21,941.

that any functional adult understands that "I work for Company X, and I think Company X's product is excellent" and would not think unbiased impartial advice is being provided. We all deal with this conversation every time we walk into a store. To be clear, however, a direct sale is just one example of these situations and we believe that the seller's carve-out should be available however a product is sold.

B. The proposal should recognize the importance of providing IRA owners and plan participants the same choice that large plan fiduciaries have – to choose if they want to enter into a fiduciary relationship.

If insurance companies and their distribution partners become ERISA fiduciaries just by selling products to IRA customers and plan participants, insurers may have to limit and restrict these types of sales, either because they are unwilling to take on fiduciary status or are unwilling or unable to comply with a prohibited transaction exemption. That means less choice, not more.

While we appreciate the Department's concern regarding the possibility of confusion by retail investors, such as IRA owners and plan participants,[22] we disagree that the Department has made the case that *as a rule*, IRA owners and plan participants are wholly and always incapable of looking out for their own interests and understanding that people in the world do not work for free. If these individuals are given sufficient information and disclosures about the retirement products, including IRA rollovers, and there are rules against making misleading statements, then informed decisions can be made.

Unless the Department expands the seller's carve-out to IRA owners and plan participants, the Department is *taking away* a choice by forcing all savers to hire (and pay for) a fiduciary simply to save for retirement.

C. Without an expanded seller's carve-out, small plans will not have access to plan investments, including annuities, and will receive no information.

We think that, with appropriate disclosure, any adult can understand when someone is acting as a seller or other counterparty, but we think it particularly troubling that the Department has limited the seller's carve-out to large plan fiduciaries. The apparent justification is that only fiduciaries of large plans are sophisticated enough to act prudently. Fiduciaries of plans, regardless of size, are required by ERISA to have a minimum level of expertise and knowledge. The Department has made clear that "[the duty of prudence] requires expertise in a variety of areas, such as investments. Lacking that expertise, a fiduciary will want to hire someone with that professional knowledge to carry out the investment and other functions."[23]

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[22] In this section, we refer to both IRA owners and plan participants, but because plan choices are largely made by the plan fiduciary, we expect that the seller's carve-out is most likely relevant for IRA owners and for rollovers to IRAs.

[23] *See* Department of Labor, *Meeting Your Fiduciary Responsibilities*, http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html (last visited July 16, 2015).

Without an expansion of the seller's carve-out to all plan fiduciaries, there is very little way to provide any information to the fiduciary of a small 401(k) or 403(b) plan beyond marketing the platform of investments. A small plan fiduciary cannot receive any guidance about guaranteed income investments that may be available for the plan if that information in any way suggests the plan fiduciary should take an action (or not take an action). (The education carve-out is not available here because any such information must by necessity reference a particular investment.) The real world effect, it appears, is that the cost of starting and maintaining a small plan will entail the additional cost of an independent adviser; the economic effects of which on plan creation and maintenance and savings outcomes do not appear to have been considered by the Department.

D. A lack of a carve-out for sales contexts will have significant adverse implications.

As described in section I, annuities are vital to our retirement system. They are critical for lifetime income from defined contribution plans and IRAs and are critical for defined benefit plans.

By most estimates, the vast majority of savers in defined contribution plans do not have access to a product that can generate guaranteed income in retirement.[24] While the Committee has supported various measures to increase the availability of annuities in plans, for most Americans saving in defined contribution plans, the only means for those who wish to obtain guaranteed lifetime income is through a rollover into an IRA annuity. ***If the proposal essentially prevents an agent, broker, or insurance company from being able to sell and explain an annuity without taking on significant fiduciary obligations and costs, annuities outside of plans will be less available and cost more when offered***.

Receiving less attention, but still critical, is the effect on annuities issued to defined benefit plans, particularly terminating plans. As best we can tell, the Department's economic analysis did not address the additional costs, and lost information, that will occur because of the expansion of the rule to the provision of annuity contracts to terminating defined benefit plans.[25] Congress requires that defined benefit plans (including small plans) "purchase" irrevocable commitments from an insurance company to provide all plan benefits upon the termination.[26] The Department's longstanding position is that the selection of an annuity provider is a fiduciary

[24] *See, e.g.*, Plan Sponsor Council of America, *PSCA 56th Annual Survey Reflecting 2012 Plan Experience*, 76 (2013) (only 17.1% of plans offer an annuity distribution). As an example, we understand that while a number of insurance companies have begun to market IRA qualifying longevity annuity contracts (QLACs) after the Treasury Department's QLAC regulations were finalized, QLACs are not available in the plan market because plan sponsors are not asking for them yet.

[25] We urge the Department to consult with the Pension Benefit Guaranty Corporation.

[26] ERISA § 4041(b)(3)(A)(i).

decision.[27] The Department also requires that a fiduciary must "conduct an objective, thorough and analytical search for the purpose of identifying and selecting providers."[28]

Thus, a fiduciary of a terminating defined benefit plan must seek out insurance companies that can provide the plan an appropriate annuity. Under the Department's proposal, however, any *recommendation* to purchase the annuity – such as responding to a request for proposal (RFP) – triggers fiduciary status.[29] It is hard to envision any interaction between a plan and the insurance company or its agent that does not involve a "recommendation" in the broad way that the proposal defines "recommendation."

Suppose a plan fiduciary contacts an insurance agent to inquire about the possibility of the agent effecting the sale of a group annuity in connection with the termination of the plan. Unless the plan qualifies as a large plan under the seller's carve-out, the agent cannot make any communication suggesting the fiduciary should purchase the annuity for the plan; otherwise the agent is a fiduciary, triggering fiduciary status, requiring the agent/fiduciary to act for the "exclusive purpose" of the plan and its participants. It is no answer that the BICE or PTE 84-24 may be available to avoid the inherent prohibited transaction. Whether or not a prohibited transaction has occurred, the agent is now a fiduciary. This means the agent can no longer do her job – explaining the attributes of the annuity and its issuer – and now must take on a role entirely inappropriate for the agent, namely acting on behalf of that counterparty plan.[30]

Put another way, the adverse consequences mentioned above do not go away simply because "there is an exemption." PTE 84-24 is not the appropriate solution for a sales context because PTE 84-24 does not prevent an insurance company or agent from having to take on fiduciary status. When a person agrees to take on an advice relationship, where the service includes impartial advice and acting in a client's best interest, that decision is done willingly and with due consideration of the additional responsibilities, costs, and risks, including litigation risks. It is entirely inappropriate to *force* someone into fiduciary status simply because they wish to market a product, and reason that the sale is not *per se* illegal because of the existence of an exemption.

[27] DOL Reg. § 2509.95-1(b).

[28] DOL Reg. § 2509.95-1(c).

[29] It is clear that an ordinary sales pitch or responding to an RFP triggers fiduciary status because the proposal includes a carve-out for such communications, but only in the context of large plan fiduciaries.

[30] For the insurance company itself, if the sale of its contract triggers fiduciary status, the company may be required to act inconsistently with its obligations to the company's shareholders or policyholders, which, after all, do not expect its business model to be a fiduciary adviser to employee benefit plans.

E. The adverse consequences mentioned above can be avoided by returning to the 2010 proposal, with appropriate additional conditions.

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, whose interests are adverse to the interests of the plan or its participants or beneficiaries, and that the person is not undertaking to provide impartial investment advice. The Department was asked to rephrase the reference to "adverse interest" to another phrase, but the concept of a seller's exception was viewed as critical to allowing parties to be able to mutually agree to the nature of the arrangement. Insurers and those who act on their behalf must be able to define the scope and nature of the services they are willing to provide, including the extent to which they are acting on behalf of the plan or a participant.

The 2015 proposal includes some refined conditions to address some of the concerns with the 2010 approach. For example, under the 2015 proposal, advice provided by a counterparty or a representative of a counterparty must fairly inform the independent plan fiduciary of the existence and nature of the person's financial interest in the transaction and may not receive a fee or other compensation directly from the plan or fiduciary for the provision of advice. These conditions are entirely appropriate additions to the seller's carve-out in the 2010 proposal. With appropriate conditions, returning to the broad seller's carve-out in the 2010 proposal is not just appropriate, it is absolutely essential to the success of the Department's proposal.

IV. <u>The Need to Make PTE 84-24 the Model and Available for the Sale of All Annuities.</u>

We understand and appreciate that the Department wants to make recommendations for the purchase of securities or other property subject to fiduciary status in many situations not covered by the current regulation. The prohibited transaction rules of ERISA section 406(b) and Code section 4975(c)(1)(E) and (F) effectively prohibit many ordinary business practices, and there is no evidence Congress wished to outlaw these business practices. Thus, we agree with the Department that a workable, principles-based exemption is critical. We have a number of very serious concerns about the BICE, detailed later in this comment letter. And we have a straightforward solution that is consistent with the Department's goals: ***PTE 84-24 should continue to be the exemption applicable to all annuities and other insurance products*.** PTE 84-24 as proposed forms a workable framework to meet the Department's frequently stated goal to allow providers to continue common and widely accepted compensation practices so long as they "commit to putting their client's best interest first and disclose any conflicts that may prevent them from doing so."[31]

The Department's long-standing position has been that a fiduciary providing investment advice will violate the provisions of ERISA section 406(b) and Code section 4975(c)(1)(E) and

[31] Department of Labor, FAQs: Conflicts of Interest Rulemaking, *available at*: http://www.dol.gov/featured/ProtectYourSavings/faqs.htm (last visited July 16, 2015).

(F) if the amount of the fiduciary's compensation, or any person in whom the fiduciary has an interest, is affected by "the use of its authority in providing investment advice" unless the payments to be received meet the requirements of an exemption.[32] Because the proposed regulation is so broad, the success of this entire proposal depends on the availability of a workable exemption that addresses the problem that the prohibited transaction rules cause many compensation practices that are common today to become illegal.

Secretary Perez testified to Congress that the proposal aims to "permit firms to continue common fee and compensation practices, as long as they are willing to adhere to basic standards aimed at ensuring that their advice is in the best interest of their customers."[33] We agree with the Secretary that we need a "principles-based approach" that will "respect existing business models" while leaving the adviser and employing firm with the flexibility and discretion necessary to determine how best to satisfy these basic standards in light of the unique attributes of their business.

The definition of fiduciary is closely tied to a number of class prohibited transaction exemptions, which provide relief from the prohibited transaction rules for certain plan and IRA transactions involving fiduciary advice. Insurers and financial professionals who distribute insurance contracts have relied upon PTE 84-24 for more than 25 years, and we believe that PTE 84-24 *has worked well*. PTE 84-24 and its predecessor PTE 77-9 have applied under six different presidents, over 35 sessions of Congress, and for many different assistant secretaries of EBSA (and its predecessor PWBA), without ever being questioned. In fact, EBSA specifically held that IRAs were covered by PTE 84-24 in 2002.[34] The existence of PTE 84-24, we believe, has helped *increase* the availability of lifetime income products in plans and IRAs. PTE 84-24 has served precisely the goals that Congress seeks for exemptions: it is in the interests of participants and IRA owners, protective of their rights, and administratively feasible.[35]

With a some important changes that we outline below, we believe that PTE 84-24, with the new Impartial Conduct Standards that the Department has proposed, can and should form the basis of a workable exemption that meets the goals Secretary Perez has laid out. Under PTE 84-24, as amended by the proposal:

- With respect to the transaction, the insurance agent or broker or insurance company person recommending the insurance or annuity contract must act in the "Best Interest" of the plan or IRA.

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[32] 80 Fed. Reg. at 21,964.

[33] Statement of Thomas E. Perez, Secretary, U.S. Department Of Labor, Before the Health, Employment, Labor And Pensions Subcommittee, Committee On Education and the Workforce, U.S. House Of Representatives (June 17, 2015) *available at*: http://www.dol.gov/ebsa/newsroom/ty061715.html (last visited July 16, 2015).

[34] 67 Fed. Reg. 9483, 9484 (Mar. 1, 2002).

[35] ERISA § 408(a).

- The insurance agent or broker or insurance company person recommending the insurance or annuity contract cannot make any misleading statements about recommended investments, fees, "Material Conflicts of Interest," or any other matter relevant to the investment decision.

- The insurance agent or broker or insurance company person recommending the insurance or annuity contract must disclose all "Material Conflicts of Interest," which is any financial interest that could affect the exercise of best judgement in rendering advice.

These conditions are principles-based, flexible for a variety of situations, and protective of the customer. They ensure the plan fiduciary, participant, or IRA owner is not misled and understands any financial interest that the agent, broker, or financial institution has in the transaction. These conditions also avoid many of the issues that make the BICE unworkable as proposed, which we detail in section XI.

Therefore, our key recommendation is that the Department build an exemption for annuity contracts and other insurance products around the Impartial Conduct Standards in PTE 84-24. To make this work, however, we have several significant comments regarding PTE 84-24.

First, we strongly urge the Department to return to the current scope of PTE 84-24, making it available to all annuity contracts sold to IRAs. Under the proposal, PTE 84-24 would not apply to the purchase by an IRA of a variable annuity or other annuity contract that is a security under federal securities laws.

We do not believe this change to the availability of PTE 84-24 makes analytical sense in light of the importance that annuities play in the retirement system. PTE 84-24 is designed, and has for years worked successfully, to provide that the simple act of a retirement plan or IRA purchasing an annuity or other insurance product does not create a prohibited transaction. In fact, 12.8 million households have an annuity in an IRA.[36] As explained in section I, annuities *provide insurance protection* and only annuities can provide guaranteed income for life – a paycheck for retirement.

The notion that variable annuities and other annuities that are securities are the same as mutual funds misunderstands that all annuities are designed to, and in fact do, provide insurance protection against longevity risk by pooling that risk among a large group of individuals, so that no single individual bears the burden of the entire risk alone. Moreover, typical variable annuities as well as other annuities that are securities provide significant insured investment guarantees that afford protections not found in mutual funds. These guarantees can be in the form of guaranteed death benefits and/or guaranteed living benefits (such as GLWBs, guaranteed minimum income benefits and guaranteed minimum account value benefits), wherein the insurer

[36] Investment Company Institute, *ICI Research Perspective,* Vol. 21, No. 1A, pp. 2, 10 (January 2015) (reporting that 31% of the 41.5 million households owning an IRA hold an annuity) *available at*: https://www.ici.org/pdf/per21-01a.pdf.

guarantees specified minimum values or payments irrespective of market fluctuations. These guaranteed benefits in turn require insurers to have sophisticated hedging programs to back up their guarantee obligations. Therefore, while variable annuities and other annuities that are securities have contract values which can vary, that does not equate them with mutual funds.[37]

Indeed, in a number of key respects, the federal securities regulatory framework applicable to variable annuities and other annuities that are securities recognizes the unique and fundamentally different nature of these annuities as contrasted with mutual funds and other securities. For example:

- Pursuant to legislation recommended by the SEC and enacted by Congress in 1996, the fees and charges assessed under variable annuities are subject to an entirely different standard under the Investment Company Act of 1940 ("1940 Act") than the 1940 Act standards, conditions and approval procedures applicable to the fees and charges assessed by mutual funds.[38] This different standard was enacted in express recognition of the insurance guarantees and actuarial underpinnings of variable insurance products – features that are totally absent from mutual funds or other investment company securities.

- In recognition of the state insurance regulatory framework applicable to insurance companies and the annuity products they issue, insurers issuing annuity products registered as securities are exempt from the periodic reporting requirements in the Securities Exchange Act of 1934 that otherwise apply to all issuers of securities registered with the SEC.[39]

- The SEC has adopted specially tailored disclosure requirements for variable annuities that focus with particularity on the insurance benefits and guarantees these products provide.[40] These disclosure requirements differ substantially from those applicable to mutual funds. Moreover, the NAIC has adopted a uniform approach to annuity disclosure, requiring the use of buyer's guides regardless of whether the annuity is fixed, indexed or variable.[41]

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[37] These guarantees and benefit forms are described in Appendix A.

[38] Amendments to Section 26 of the 1940 Act made under Section 205 of the National Securities Markets Improvement Act of 1996 replaced specified limits on the amount, type, and timing of charges that apply to variable insurance contracts. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290 (codified at 15 U.S.C.A. § 80a-26(f) (2009)). The amendments require the sponsoring insurance company for a variable insurance contract to represent, in the registration statement for such contract, that the charges deducted under the contract meet a "reasonableness" test. *Id.*

[39] 17 C.F.R. § 240.12h-7 (2014).

[40] SEC Form N-4, which is used for registration of separate accounts organized as unit investment trusts that offer variable annuity contracts, is available at: https://www.sec.gov/about/forms/formn-4.pdf (last visited July 16, 2015).

[41] NAIC, ANNUITY DISCLOSURE MODEL REGULATION (Model 245) (buyer's guide adopted 1998; model regulation adopted 1999, amended 2011).

- FINRA has adopted a special suitability rule for variable annuities whose requirements differ in a number of significant respects from FINRA's general suitability rule applicable to mutual funds and other securities.[42] And it is particularly important to note that the model suitability regulation that the NAIC has adopted for <u>all</u> annuities is very closely modeled on FINRA's suitability rule, thus insuring that all annuity products, irrespective of whether the annuities are fixed or variable, are subject to substantially the same suitability regulatory framework.[43]

Annuities that are securities under the federal securities laws (such as variable annuities) and those that are not, all have advantages and disadvantages; none is inherently better than the other. In contrast, the BICE, by design, entails significantly more conditions and thus significantly more cost. If certain kinds of annuities must be sold only through the BICE, there will be an incentive for one kind of annuity. We strongly believe that retirement savers should choose one product over another based on the actual economic benefit and what best serves their needs; not based on which annuity is subject to one prohibited transaction exemption or another. Public policy dictates that government regulation not impose differing regulatory requirements on the insurance industry that will create an unlevel market for its annuity products and result in serious unintended consequences and costs for retirement savers.

We want to be clear. Our concern about the distinction the Department has proposed in PTE 84-24 between kinds of annuities does not mean all annuities should be forced into the BICE. For a variety of reasons, BICE is not suited for annuities. Nonetheless, if the Department intends to create a single exemption like BICE that will apply to variable annuities (or any other kind of annuity), this single exemption should consist of simplified conditions based on the straightforward and workable conditions in PTE 84-24.

<u>**Second**</u>, it is critical that the Department confirm that Section I(a)(4) of PTE 84-24 provides relief for the purchase of an insurance company's own contract if the insurance company becomes a fiduciary under the new rule, and *covers the compensation inherent in the contract itself*. It has long been understood in the industry that Section I(a)(4) provided this relief – in fact it must provide relief for proprietary sales or it does not provide meaningful relief at all.[44] Because of the importance of PTE 84-24 as a result of the wide net the proposal will cast, the scope of Section I(a)(4) of PTE 84-24 is no longer a theoretical question.

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[42] FINRA Rule 2330: Members' Responsibilities Regarding Deferred Variable Annuities (imposing heightened suitability, disclosure, supervision and training obligations in connection with the sale of variable annuities).

[43] NAIC, SUITABILITY IN ANNUITY TRANSACTIONS MODEL REGULATION (Model 275) (adopted 2003; amended: 2006, 2010).

[44] To explain further: Section I(a) of PTE 84-24 provides relief from the self-dealing prohibitions in section 406(b) of ERISA and section 4975(c)(1)(E) and (F) of the Code. This means that it is providing relief for transactions that otherwise involve a fiduciary dealing with plan assets in its own interest, acting in a transaction on behalf of an adverse party, or receiving compensation from a third party in a transaction involving plan assets. Section I(a)(4) provides relief for the "purchase, with plan assets, of an insurance or annuity contract from an insurance company." A violation of the self-dealing rules could arise in the sale of an annuity where the insurance company or someone with an interest in the insurance company (like an affiliate or employee) is a fiduciary and the

When an insurance company sells an annuity, the contract generally provides the insurance company with one or more types of compensation in exchange for the benefits of the contract. First, the insurance company will receive any *spread* between the amount guaranteed in the form of guaranteed return or annuity payments and the earnings in the insurance company's general account. Sometimes, the cost of the guarantee will be paid directly in the form of mortality and expense and similar insurance charges. Second, insurance-dedicated mutual funds and other investments that support the separate account of a variable annuity contract will provide payments to the insurance company in recognition of its costs associated with indirectly marketing those investments to policyholders and other services provided to the investments and contract. If the contract includes proprietary investments, the insurance company or an affiliate will receive a management fee. It is entirely appropriate for PTE 84-24 to cover all of these payments and direct and indirect compensation, as long as the insurance company meets the Impartial Conduct Standards with respect to any advice provided, including a description of any Material Conflict of Interests that the insurance company may have.[45] Accordingly, we recommend that the Department clarify that Section I(a)(4) provides relief for "all direct and indirect compensation received by an insurance company in connection with the purchase, with plan assets, of an insurance or annuity contract from the insurance company."

Third, if PTE 84-24 is going to provide meaningful relief, the kinds of compensation that are covered under Section I(a)(1) must be expanded beyond the new narrow definition of an "Insurance Commission." The new definition of "Insurance Commission" makes an artificial distinction between sales commissions paid "by the insurance company or an Affiliate to the insurance agent or broker or pension consultant for the service of effecting the purchase or sale of an insurance or annuity contract, including renewal fees and trailers," on one hand, and "revenue sharing payments, administrative fees, marketing payments, or payments from parties other than the insurance company or its Affiliates," on the other. We see no policy reason that the exemption should be limited to a narrow definition of "commissions." All of these payments compensate the agent or broker for effecting the purchase or sale of an insurance or annuity contract and for providing associated services, including explaining the product. All of these other payments are common in the industry and are important to support the distribution and effecting of annuities in various distribution methods. Accordingly, we recommend that the compensation covered by the exemption be amended to cover "any direct or indirect compensation paid to the insurance agent or broker or pension consultant for the service of effecting the purchase or sale of an insurance or annuity contract."

Fourth, Committee members are concerned with how the Department has described the "best interest" standard. The standard is intended, it appears, to replicate the duties in ERISA

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compensation *inherent in the product itself* otherwise runs afoul of the rules. Accordingly, Section I(a)(4) must provide relief for this or it does not provide any relief, and the Department does not create exemptions where there is nothing to exempt.

[45] Accordingly, we are comfortable with the notion that an insurance company would disclose that the compensation inherent in the contract creates a material conflict of interest. This does not mean we think that a dollar-based disclosure of the "spread" is appropriate (even if it were possible, which it is not). It should be sufficient, for example, for a disclosure to state: "Insurance Company X has a financial incentive to sell this product because it retains any return on the assets above the amount that is guaranteed to you under the contract."

section 404, but includes a significant additional requirement that Congress did not impose under ERISA. The "best interest" standard requires that any advice be provided "without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party." This particular standard presents unique litigation risks because it is hard to imagine any business enterprise ever acting *completely without regard to its interests.* We think that the enunciation of prudence in ERISA section 404, which looks to the actions of a prudent fiduciary in circumstances similar to those then prevailing, is a more straightforward test, one actually approved by Congress and that has stood the test of time. In any event, the Department needs to clarify – in the text of the exemption and not just in the preamble – that a duality of interests can exist provided the customer's is placed ahead of the adviser's.

Fifth, we recommend that the Department confirm that PTE 84-24 covers payments that are not paid directly to the insurance agent or broker but are paid to someone that oversees the agent or broker working directly with customer. These are sometimes called "override" commissions or dealer "concessions." Ultimately, like a traditional commission, these payments compensate for the distribution of the contract.

Sixth, we recommend that the Department confirm that PTE 84-24 provides relief for compensation structures used with common law employees of an insurance company and "career" agents.[46] Many insurance companies use their own employees to sell insurance and annuity contracts or use career agents, and these individuals will receive compensation that would not normally be categorized as a commissions, including salary and bonuses, overtime pay, and benefits like health and retirement benefits. It would be odd if the exemption were available for cash commission to an independent agent but not a payment or benefit in another form for the same service to a customer.

Seventh, we recommend that the Department provide guidance on what it means to disclose a "Material Conflict of Interest." As proposed, a Material Conflict of Interest is any financial interest that could affect the exercise of best judgement in rendering advice. While the defined term is "Material Conflict of Interest," the definition of the term does not actually contain a materiality element. As a result, *any* financial interest that "could" affect the judgement of a fiduciary becomes a Material Conflict of Interest. This is potentially limitless, which is not what we believe the Department intended. We think that the Department intended to focus on material financial interests, such as a commission or other material payment that will be received in connection with the purchase or sale of an insurance or annuity contract.

We appreciate that there has been some attention on awards provided to successful agents and brokers. If an individual or his firm has an arrangement that could result in material non-cash compensation, we think this should be disclosed. A disclosure that the agent or broker will be eligible for incentives is appropriate. In contrast, we think that ordinary business entertainment and reimbursement of travel to conferences for education on products, which are

[46] A "career" agent is generally an agent that primarily represents one company and principally sells only that company's contracts. While not a common law employee, a career agent may receive compensation roughly analogous to that received by a common law employee.

not related to a particular sale, are not "material." We caution that the focus of the disclosure should be on the incentives – a commission being of most importance – that materially relate to that customer. Otherwise, the disclosure of Material Conflicts of Interest will obscure the key disclosure, namely the commission to be paid.

Eighth, we urge the Department to confirm that PTE 84-24 stands on its own. By this we mean that PTE 84-24 should be available to provide relief for the transactions it describes even if the agent, broker, or insurance company (or an affiliate) could sell other products not encompassed by PTE 84-24. The Department has always taken the position that if an exemption is available for a transaction, then that exemption may be used to provide relief. Thus, if the sale of an insurance or annuity product meets the conditions of PTE 84-24, it should be available even if the agent, broker, or insurance company can sell products that are not within the scope of PTE 84-24.

V. The Need to Clarify the Test for Fiduciary Status to Avoid Sweeping in Non-Fiduciary Communications.

The Department's goal, which we share, is to draw the right line between conversations that involve "investment advice" as Congress intended, and those that do not. We offer a number of comments to assure that ordinary conversations regarding annuities do not trigger fiduciary status.

Under the proposal, a communication that appears to suggest the acquiring of a security or other property triggers fiduciary status if there is an "agreement, arrangement, or understanding" that the advice is "individualized" or "directed to" the recipient for consideration. The line between those communications that are "individualized" or "directed to" someone is unclear, and yet the line that separates fiduciaries and other service providers that furnish important information is the foundation of ERISA. Because of the breadth of the Department's proposal, a variety of conversations that are not fiduciary in nature could inadvertently trigger fiduciary status. It is critical that insurance companies and others be able to discuss their products with plan fiduciaries, participants, and IRA owners. To take some real world examples:

- *Strength of insurer.* Imagine an IRA customer is seeking information about an annuity, and the agent is trying to be careful not to portray himself as providing investment advice. The customer states that she wants to be sure that the annuity payments will always "be there for my entire life, so I can sleep at night." The agent provides information that the insurance company issuing the annuity is highly rated. Because the customer has expressed a factor that is important to her decision, the agent has apparently made a suggestion that could be viewed an "individualized" to the customer.

- *Annuitization and withdrawal options.* When a participant or IRA owner owns a deferred annuity, the participant or IRA owner often has a variety of choices in managing the annuity, including the ability to annuitize the contract at some point. These potential features may include a life annuity, a joint and survivor annuity, or an annuity with cost of living increases. The annuity might also provide a guaranteed withdrawal benefit, allowing the individual to take withdrawals from the contract up to a specified level and to continue doing so for as long as he lives even after the account value is reduced to zero.[47] Information regarding the advantages and disadvantages of annuitization, withdrawals subject to a guaranteed withdrawal benefit, or other options to receive distributions from the contract should not be viewed as an individualized recommendation simply because the discussion will mention certain facts that might be relevant to the decision. For example, a communication regarding annuitization might point out that those with a short life expectancy should not annuitize.

- *Risk profiles.* It is common for those working with retirement savers in plans and IRAs to help customers make informed decisions through "risk profiles." For example, those who have the lowest tolerance for risk generally gravitate to product X with little market risk, and those with higher tolerance for risk generally gravitate to product Y. Again, these risk profiles are not created with a particular customer in mind, and yet because they assist a customer in placing himself or herself in a category, could be viewed as triggering fiduciary status, which we do not think the Department intended.[48]

- *Age profiles.* Similar to risk profiles, companies often communicate age-based information. For example, companies with target retirement products will help individuals understand the products by sorting them into intended age groups by expected retirement date. A communication that lists products and notes the age ranges to which the products are intended could appear to be "individualized" simply because such a communication uses an individual characteristic (age) to sort the products. But provided the communication does not suggest someone has considered *this individual's* needs, such a communication should not be considered fiduciary advice.

More generally, the Department should carefully consider how the proposal sweeps in conversations that do not suggest fiduciary status. We think that a number of improvements could be made to refine and clarify the test for fiduciary status and avoid inadvertent foot faults:

First, "directing" a communication at an individual should not be part of the test. Targeted communications are common with plan participants and IRA owners. For example, an insurance company may target a communication at an annuity owner that is approaching a particular age and may want to consider annuitization. Communications often are *addressed* to an individual, but that should not mean a fiduciary obligation has been created or should be expected. We urge the Department to remove the reference to a communication that is "directed to" the recipient.

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[47] The "withdrawals" made after the account value is reduced to zero are actually payments to the owner made by the insurer from its own funds.

[48] These risk profiles often sort particular products into a straightforward and easy to understand risk spectrum. In doing so, the products necessarily must be mentioned. If the Department adopts our recommendation to revise the education carve-out to allow reference to particular products, this concern will be lessened.

Removing the reference to "directing" a communication will help clarify that merely using the word "you" should not be enough for a communication to be considered individualized or directed at an individual. For example, a communication might say "you might consider" or "this option might be right for you if you are nearing retirement." But that alone should not trigger fiduciary status. The Department's own publications for plan participants use the word "you" repeatedly, and no reasonable person would think these communications are "directed at" a particular individual.[49]

Second, the fact that a communication is "for consideration" in making decisions is too low a bar. Virtually anything that is informative is intended to be considered in making decisions. In fact we can think of no information, written or verbal, that is *not* supposed to be considered by the recipient. We appreciate that the Department wishes to revisit the current regulation's requirement for a "mutual agreement" that advice will be the "primary basis" for decision making. There is clearly a middle ground. For example, the Department should consider a requirement that there is a "reasonable expectation that the advice will be relied upon" in making decisions, or will be a "material part of the decision making" and amend the regulation to incorporate these more appropriate standards.

Third, the Department should revise the proposal to make clear that simply because a communication references facts, like age, expected retirement date, risk tolerance, safety of an annuity issuer, or longevity, that help individuals understand the pros and cons of an investment product, choice, or strategy, does not mean the communication has been "individualized."

Fourth, the Department should clarify that if a person accidentally falls into fiduciary status because a conversation slips into a recommendation, the fiduciary obligations are limited to the information provided that would constitute a "recommendation." The proposed test for a "recommendation" lends itself to foot faults, but that should not subject someone to an unending fiduciary obligation.

Fifth, the Department should revise the definition of "recommendation" to require more than a "suggestion" that a course of action be taken (or not taken). This is too low a bar. We recommend that the definition be revised to require a "call to action" or advocacy for a course of action.

Sixth, the Department should amend the proposal to allow a carve-out where there is no reasonable expectation of fiduciary status. The foregoing comments all are aimed to try to avoid inadvertently catching non-fiduciary communications and conversations. We think that the importance of this issue suggests the Department should consider a "catch-all" rule. We agree that, when the overall context would create a reasonable understanding between the plan fiduciary, participant, or IRA owner and the adviser that recommendations will be made in the recipient's best interest, will be impartial, and that a relationship of trust and confidence should be expected, then fiduciary status should attach. Conversely, if there would be no reasonable

[49] For example, see Department of Labor, What You Should Know About Your Retirement Plan, *available at*: http://www.dol.gov/ebsa/publications/wyskapr.html, which uses the word "you" or "your" more than 600 times.

expectation that impartial advice will be provided, no fiduciary status should attach.[50] We suggest a "catch-all" rule that avoids fiduciary status if, under the facts and circumstances, there is no reasonable expectation that the impartial advice is being provided.

Clarifying the scope of fiduciary status. In addition to the foregoing, given that many more individuals and entities will become fiduciaries under the proposal, clarification is needed to ensure that fiduciary status is contained to those that should be considered fiduciaries, and not affiliates and product manufacturers.

To illustrate, take a common example. (We return to this example later in our letter in the context of the BICE's definition of "Financial Institution.") Imagine a large financial services institution that has an affiliated registered investment adviser (RIA), an affiliated retail broker-dealer (BD), and an affiliated licensed insurance agency (IA). To sell fixed and variable insurance products, BD and IA enter into selling agreements with various insurance companies, to make the products of those insurance companies available to their representatives (who are also registered Investment Adviser Representatives of the IA) for sale to the customers of BD. Under state insurance laws, among other requirements, an agent must be "appointed" as an agent by an insurance company to sell insurance products of that particular insurance company.

Imagine that a representative so appointed provides a recommendation (that meets the Department's new rules) to a customer to purchase a variable annuity contract from an unaffiliated insurance company. This is done by the representative in his investment advisory capacity for RIA, executed in his registered representative capacity for BD, and executed as an insurance agent of IA.

First, it should be very clear that the *insurance company* that manufactured the variable annuity contract is not a fiduciary simply because state law requires an "appointment" of the insurance agent. We do not believe the Department intended that the product manufacturer was to be a fiduciary under the proposal merely because state insurance law requires that the persons that sell its products are required to be appointed with the insurance company. Second, while the RIA entity may be considered a fiduciary because the representative is licensed as an investment adviser representative to provide advice, neither BD nor IA, nor any other affiliate of the financial institution, should be considered a fiduciary. This conclusion is in line with the Department's longstanding view that while affiliates of fiduciaries may be parties-in-interest, they are not automatically fiduciaries.[51] Please see a further discussion of this issue in Section XI of our letter, related to BICE.

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[50] We understand that the Department is concerned that carve-outs could be used as loopholes, where an adviser acts as if he is in a position of trust and confidence, but provides a small print disclaimer. We do not support such actions. Thus, a carve-out along these lines could fairly be based on the overall facts and circumstances, not just on boilerplate disclosures.

[51] There is a slight ambiguity in the proposal because Section (a)(2) refers to providing advice "indirectly" through an "affiliate." To avoid this confusion and ambiguity, the definition should be modified accordingly to make clear that an affiliate of a person shall not become a fiduciary solely as a consequence of facilitating an indirect representation or rendering of advice.

VI. <u>The Need to Carve Out Distribution Advice that Does Not Involve an Investment Recommendation.</u>

We continue to believe, as we did in 2010, that advice regarding distribution options available under the plan, if that distribution involves no *investment* recommendations, is not "investment advice" within the meaning of ERISA. Had Congress wanted *distribution* recommendations to be considered fiduciary in nature, Congress could easily have said so; in fact Congress has frequently provided rules to protect participants in the context of distributions.[52]

There is no inherent investment element in a plan distribution. Consider, for example, a plan participant who contacts a plan's call center to discuss a hardship distribution, or to discuss a loan from a 403(b) contract. The call center representative may have a set of talking points to explain the adverse implications of a hardship distribution or loan, including the loss of retirement income, restrictions on future contributions, and significant tax consequences. This will likely be viewed as a recommendation not to take a hardship distribution or loan and would trigger fiduciary status. But we see no evidence Congress intended this conversation to be considered "investment" advice. Investment advice should be limited to advice regarding securities and other property (and the related rights), not to the inchoate rights associated with simply being a participant.[53]

This is also important for IRAs, because under the proposal a suggestion regarding a "distribution" from an IRA would be fiduciary investment advice. Take a simple example. Imagine the owner of an individual retirement annuity calls the insurance company to discuss her options to take withdrawals from the contract and understand the various implications of taking a withdrawal and not taking a withdrawal. The call center will describe those options, and because of certain facts the IRA owner provides, suggests that one course of action may be better suited for the IRA owner. For example: "You told me you want to have some of these assets available for unexpected medical expenses. You should consider taking a withdrawal rather than annuitizing at this time.") This would hardly fall under the meaning of "investment advice" by its ordinary definition. We recommend that "distribution" advice that involves no investment recommendations be excluded from the rule.[54]

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[52] There are already mandated disclosures that specifically address the impact associated with a participant's decision not to defer a distribution. In this regard, Congress has directed the Treasury Department to modify the disclosures required under section 411(a)(11) of the Code to include a description of the consequences of failing to defer. Pension Protection Act of 2006, Pub. L. No. 109-280, § 1102(b); Prop. Treas. Reg. § 1.411(a)-11(c). Similarly, Congress created a specific notice under section 402(f) of the Code addressing rollovers. The point here is that Congress knows the difference between "investment" and "distribution" advice.

[53] Similarly, some plans allow the participant to distribute an annuity held under the plan "in kind" so that the participant can continue any insurance protections. This is a distribution decision, not an investment decision.

[54] This should include routine advice about ways to manage an annuity to comply with the complex required minimum distribution ("RMD") rules set out in the Treasury regulations under Code section 401(a)(9).

VII. <u>The Need to Preserve Valuable Education.</u>

We support the proposal's inclusion of language to make clear that education regarding lifetime income is covered, including education regarding (a) annuitization and other forms of lifetime income payment options, (b) retirement-related risks, (c) methods and strategies for managing assets in retirement, and (d) estimating a retirement income stream. It is critical that individuals understand how to manage their assets in retirement and are educated about the options available to them. We also support a clarification that the education carve-out is available for IRAs and plan fiduciaries.

On the other hand, the proposal makes a striking, and in our view, ill-advised, change to Interpretative Bulletin (IB) 96-1. Under the proposal, education cannot (standing alone or in combination with other materials) make any recommendations regarding specific investments or other property. We are aware of no evidence that IB 96-1 is used now as a subterfuge for providing investment advice. To the contrary, it has been very successful in bringing education programs to participants.

In the context of lifetime income, this change to IB 96-1 will have a series of unintended and harmful effects. The owner of an IRA annuity always has the option to annuitize her contract and that option must be *explained* to the IRA owner. Likewise, if a plan offers an annuity distribution option, the option must be *explained* to the participant. It is not conceivable that an IRA owner or plan participant could be educated about the annuity distribution options without mention of the actual annuity product given the variety of annuity options available in the market and the nuances of individual products. Indeed, failing to do so would seem to be misleading.

Implications for IRAs. IRA owners that purchase deferred annuities with an annuitization option, guaranteed lifetime withdrawal benefit, or other features, need to understand those options. For example, imagine an individual purchases a deferred variable individual retirement annuity that allows for annuitization at a later date. When the individual retires, he contacts the insurance company or his agent to understand his options. This is exactly the kind of education that we think the Department is hoping to facilitate. And yet the conversation will need to reference the annuity that the individual purchased, thereby triggering fiduciary status.

A similar and common conversation that occurs with the owner of an individual retirement annuity is education regarding the taking of required minimum distributions ("RMDs"). When an IRA owner reaches her "required beginning date," she will need to make some fairly sophisticated decisions about how and when to take withdrawals or to annuitize consistent with the IRS' complex RMD regulations. A withdrawal generally must satisfy the "account" rules for defined contribution plans, while an annuitized contract must satisfy detailed limits on the annuity payout stream. These conversations all occur under the rubric of the specific annuity contract the individual owns.[55]

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[55] One Committee member mentioned a common related conversation: Imagine an employee does not need to access his 403(b) savings at age 70½ and expects to continue working past that age. The employee asks his agent about rolling the funds into an IRA. The agent should be able to tell the employee that it is disadvantageous to roll

It is critical that these conversations fall under "education," because under the Department's proposal, they will be "directed at" the individual and could easily be understood as a "suggestion" for a particular course of action. For example, the statement "if you expect to have longer than average life expectancy, then annuitizing your contract may be right for you" is individualized, directed at the individual, and suggests a course of action. A similar statement in the RMD context might be: "if you want your payments to ramp up significantly in the next couple years, then you may wish to take withdrawals rather than annuitize, because the RMD rules require annuity payments to be basically level. However, your contract does offer an annuity payout option that has certain payment increases that continue as long as you live." Further, owners of annuity contracts have to understand the advantages, disadvantages, and trade-offs of various options for them under the contract, and this education will by necessity "reference the appropriateness" of the specific product and options.

Implications for plans. In the context of participant directed plans, education about asset allocation must mention the specific investments that the plan fiduciary has chosen or it will be meaningless to the participant. An education document or interactive web program that suggests a particular asset allocation but does not connect that to the actual investments in the plan is useless. Again, because a communication or interactive model is trying to get the individual to take action, such as diversifying her account, it must fall under education because it would otherwise appear to be a "recommendation" under the Department's broad definition. It is entirely appropriate for a service provider to simply connect an educational communication with an investment *that has been selected by the plan fiduciary.*

In most 401(k) and 403(b) plans, the service provider to a plan is typically providing education at the direction or behest of a plan sponsor. The educational program is overseen by the fiduciary, who generally does not have a prohibited transaction concern (and would not receive a fee for any "advice" provided). A service provider, on the other hand, who does not intend to be a fiduciary, cannot fall into fiduciary status because of the prohibited transaction concerns. Thus the Department should make clear that a service provider is not viewed as making a recommendation solely by implementing the plan fiduciary's instruction to provide education about the plan's investment options, if the education is subject to the review and oversight of the plan fiduciary.

Information about the product itself. The education carve-out is designed for education. There are many conversations that insurance company call centers have with customers that simply provide factual information about the product that the individual owns.[56] We are concerned that call center employees – fearful of personal liability – will be wary of providing

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over his 403(b) into an IRA because he is not required to take minimum distributions from his 403(b) at age 70½ if he is still working but would be required to take RMDs if he rolled over into an IRA.

[56] Common questions include: "What would be my surrender charge if I take a withdrawal?" "How much of a withdrawal can I take and not have a surrender charge?" "How many years left on my surrender charge period?" "Do my contract investment options include a small cap fund? *Yes*. What is it? *ABC Fund*. What is its fee? *X%*. OK, please transfer $XXX to that fund for me." The bar for a recommendation – any communication that would be perceived as a "suggestion" that the customer take an action or not take an action – means even mundane factual conversations raise the risk of litigation.

even factual information about a product if that factual information might appear to "suggest" that a customer take an action or not take an action. Thus, we recommend that any information or explanation regarding an investment that is disclosed in the investment's relevant prospectus or similar disclosure can be provided without triggering a "recommendation." Similarly, factual information about the tax consequences of a product or exercising any option under the contract should be protected from treatment as a "recommendation."[57]

VIII. <u>The Need for Clarifications Regarding the Platform Carve-Out.</u>

Under paragraph (b)(3) of the proposal, it is not considered investment advice if a person:

> merely markets and makes available to an employee benefit plan (as described in section 3(3) of [ERISA]), without regard to the individualized needs of the plan, its participants, or beneficiaries, securities or other property through a platform or similar mechanism from which a plan fiduciary may select or monitor investment alternatives, including qualified default investment alternatives, into which plan participants or beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts, if the person discloses in writing to the plan fiduciary that the person is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity.

As an initial matter, we think this "platform carve-out" is simply a common sense expression of current law. It cannot be "investment advice" for a service provider to put together a product – in this case a menu of available investments – which is offered generally to the market or segments of the market. We recommend below some clarifications to ensure the platform carve-out is effective.

<u>First</u>, ***the Department should confirm that the platform carve-out is available to investments available through variable annuities.***

Although there is no formal definition, the platform carve-out implicitly defines a platform as a mechanism from which a plan fiduciary can select or monitor investment alternatives into which participants may direct the investment of their accounts. Appropriately, the definition does not specify the legal structure under which these investments must be offered.

Many plans use individual and group variable annuities as the method to provide access to a platform of investments to which participants allocate their account. For example, in the 401(k) market, it is very common for an insurance company to offer a group variable annuity

[57] A similar example: Imagine an employee is getting a divorce from his spouse and they enter into a QDRO agreement agreeing to split the $80,000 cash value of a section 403(b) annuity owned by the employee. The spouse asks the servicing agent about how to best access the money, since her $40,000 cannot remain in the 403(b) annuity. The agent should be able to tell the spouse that is advantageous to roll over her portion of the 403(b) annuity into an IRA, which is preferable to a distribution from the annuity because spouse avoids penalty taxes and withdrawal charges.

with a separate account holding investments.[58] During the accumulation phase, these various investments are available for participants to direct the investment of their accounts.

Section 403(b) plans must be held in an annuity or a mutual fund custodial account. Annuities used in 403(b) plans are often individual annuities, although not exclusively. The plan sponsor may make available the annuity of only one vendor or multiple vendors. In any case, as long as a provider's annuity is a "mechanism" under which investments are offered into which participants may direct the investment of their account, we believe the platform carve-out should apply.

We very much appreciate that the Department clarified in the preamble that the platform carve-out is available in the 403(b) plan marketplace. To implement this commonsense interpretation, we think it would be very helpful for the Department to clarify that in multi-vendor plans, each provider's contract can qualify as its own platform if it qualifies. (Otherwise, it might inadvertently be investment advice to market one's own platform without discussing the other vendors available in the plan.)

A contrary interpretation would place insurance companies at a significant disadvantage by, apparently, making it a fiduciary act to simply "market" a group or individual annuity that serves as a mechanism to select or monitor the plan's investment line-up. We do not believe the Department would intend that result.

Second, ***the Department should confirm that a "platform" can be a preset list of investments that can be selected and monitored as a whole by the fiduciary.***

Not all "platforms" consist of a platform of thousands of mutual funds or other securities that a plan fiduciary must narrow. Some providers will make available a pre-set menu of investments that is available for selection but has not been individualized to the needs of any particular plan. In fact, a variable annuity may have a list of investments available under the contract that are described in the prospectus and available to all investors that purchase the annuity. We believe the Department intended these platforms to fall under the carve-out. As long as the provider has not individualized the platform to the needs of a particular plan or participant, and has made clear it is not undertaking to provide impartial investment advice, the platform carve-out should be available.[59]

Similarly, some Committee members have expressed concern that the platform carve-out requires the offering of non-proprietary investments. After carefully reviewing the language and the discussion of the platform exemption in the preambles to the 2010 and 2015 proposals, we think the Department did not intend this implication. We see no evidence the Department

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[58] The insurer may also offer a general account investment as part of the line-up, such as a stable value product or guaranteed return product.

[59] The Department made some subtle, but important, changes to the language for the platform carve-out from the 2010 proposal. For example, the platform carve-out has been changed to a platform from which a plan fiduciary "select ***or monitor***" investment alternatives.

intended to force a particular platform distribution model. Nonetheless, we think it would be helpful for the Department to clarify this point through a discussion in the preamble to the final rule.

<u>Third</u>, ***the platform exception should not be limited to ERISA plans.***

As we stated in our prior comments, the Committee firmly believes that the platform carve-outs should also apply to IRAs and Keogh plans.[60] Many IRA providers limit the investments that may be selected through the IRA to a specified universe of investments. These investments may be solely proprietary or may include both proprietary and non-proprietary investments. The mere marketing of such an investment platform should not be viewed as investment advice to IRA owners. This should be self-evident because *simply limiting the universe of investment on an IRA platform* that is available to customers is not an individualized recommendation to any IRA customer where the IRA platform provider has made clear that it is not undertaking to provide impartial investment advice.

<u>Fourth</u>, ***"marketing" a platform should include the furnishing of a sample or initial menu of investments.***

When a plan fiduciary seeks a plan provider, the fiduciary often asks the provider to suggest a sample menu that can be used to evaluate the pricing of the provider. The provider may put together this sample menu in response to a specific request in an RFP, or may do so to feature the breadth and quality of the investments available through the provider. As long as the context makes clear that the sample menu is just that – a sample – and that the provider is not undertaking to provide impartial investment advice, there should be no assumption of fiduciary status. Rather, such a sample menu is part and parcel of the marketing that the platform carve-out is intended to facilitate.

IX. <u>The Need to Clarify that Routine Annuity Valuations Are Not Fiduciary.</u>

The Department has made some significant improvements to the rules for "valuation" advice, which the Committee appreciates. First, the Department clarified that an appraisal, fairness opinion, or similar statement regarding the value of a security is considered advice only "if provided in connection with a specific transaction or transactions involving the acquisition, disposition, or exchange, of such securities or other property by the plan or IRA." Second, the Department provided a carve-out for statements of value provided to pooled separate accounts. Third, the Department expanded the carve-out for statements of value provided "solely for purposes of compliance with the reporting and disclosure provisions under [ERISA], the Code, and the regulations, forms and schedules issued thereunder, or any applicable reporting or disclosure requirement under a Federal or state law, rule or regulation or self-regulatory organization rule or regulation."

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[60] For this purpose, a Keogh plan is a plan covering only a business owner (and his or her spouse), which is not considered an employee benefit plan because it does not cover any employees.

Informal statements from Department officials indicate that the Department's primary concern is the purchase and sale of nontraditional assets like real estate by a plan where the plan fiduciary receives an appraisal or similar opinion regarding the value of the asset. We are concerned, however, that because the term "transaction" has been interpreted broadly by the Department in other contexts, the proposal inadvertently sweeps in routine and somewhat mechanical valuations that insurance companies may need to perform for policyholders.

The following situations involve statements of value that may not neatly fall into one of the Department's carve-outs:

- *Roth IRA conversions.* An IRA annuity owner may contact an insurance company to request the value of his or her annuity because the owner is contemplating converting the annuity to a Roth IRA. If the IRA owner decides to perform the conversion, the owner will have taxable income. Treasury regulations require that the amount of taxable income is based on the fair market value of the annuity on the date of the conversion.[61] IRA owners look to the insurance company to calculate this amount, as the insurance company is in the best position to perform the actuarial calculation. If the conversion occurs, it will ultimately be reported the IRS, but that is not the sole reason for the furnishing of the statement of actuarial value, *e.g.*, the IRA annuity owner's decision on whether to make the conversion may depend on the amount of income that she will recognize and this in turn depends on the insurance company's valuation.

- *Required minimum distributions.* Owners of IRA annuities that have not yet been annuitized are required to take a withdrawal upon reaching the required beginning date under section 401(a)(9) of the Code. Treasury regulations require that the amount of the withdrawal be based on the "dollar amount credited to the employee or beneficiary under the contract plus the actuarial present value of any additional benefits (such as survivor benefits in excess of the dollar amount credited to the employee or beneficiary) that will be provided under the contract."[62] Insurance companies routinely report this information using reasonable actuarial assumptions (which the regulations require) to policyholders subject to RMDs. The information is commonly provided annually on a form (IRS Form 5498, box 5) that an insurer is required by the IRS to file. However, the furnishing of this information is done so that the policyholder can take a withdrawal, which would seem to be a "transaction" in the broad sense, and the information may be furnished to an owner other than at the time and in the manner required by the IRS.

- *Routine account balance inquiries*. There are numerous instances where an insurance company may respond to an annuity contract owner's request for contract value information. Contract value information is often also made available to the annuity contract owner through a website or other automated system. For fixed contracts, the value would be updated to reflect interest credits through a specified date. For variable

[61] Treas. Reg. § 1.408A-4, Q&A-14.

[62] Treas. Reg. § 1.401(a)(9)-6, Q&A-12(b).

contracts, the value would be updated to reflect the net asset value of the underlying mutual funds or other securities through a specified market close. The current surrender charges would be available. The actuarial value of other contract benefits, such as GLWBs or guaranteed minimum death benefits, may or may not be available depending on the capacity of the insurance company's computer systems. This request of the owner for contract value information may relate to a contemplated withdrawal from or surrender or exchange of the annuity contract, or a contemplated loan if the contract is part of a qualified plan that permits loans. (These values may also be provided in paper or online account statements, which often have a coupon or online option to make subsequent contributions.)

- *Contract allocations*. Most fixed indexed annuity contracts and registered indexed annuity contracts allow the owner to reallocate funds among the available fixed and indexed investment strategies at the end of each specified term. At the end of a term, the insurance company will routinely provide information about the amount coming up for renewal. Variable annuity contracts generally allow the owner to reallocate amounts among the underlying mutual funds or other securities, and the insurer will routinely provide information concerning the balance in each option for that purpose.

- *Living benefits and death benefits.* Increasingly, IRA owners are purchasing guaranteed lifetime withdrawal benefits and similar "living benefit" guarantees. These additional benefits provide a guarantee of a minimum withdrawal from the contract despite longevity and market conditions. IRA owners routinely contact the insurance company to inquire about the value of the living benefit guarantee and ask how a withdrawal will affect the value of the guarantee. An IRA owner may also inquire about how a withdrawal may affect an enhanced death benefit provided for under the contract.

All of these situations involve an insurance company applying certain actuarial principles or algorithmic calculations to assist IRA owners in understanding the value of the contract or in complying with complex tax code requirements. Many of them will *result* in the issuance of a federal tax form like Form 1099-R (but not all), but that is not the sole purpose for furnishing the information. We urge the Department to either clarify that such routine valuations are not advice as contemplated by the proposal, or expand the various valuation carve-outs to encompass them.

X. <u>The Need to Preserve Advice Programs Under Current Law.</u>

Many Committee members and their affiliates already offer advice programs to plans and IRAs, either directly or through a third party. These programs involve the acceptance of fiduciary status and structuring the compensation to avoid any prohibited transactions. For example, the company may offer access to an unaffiliated third party advice service or unaffiliated adviser. Others offer computer model advice similar to the programs described in Advisory Opinion 2001-09A (SunAmerica). The proposal itself, and the new and amended exemptions, do not explicitly address these existing and successful advice programs. A number of features of the proposal, however, seemingly call them into question, and we urge the Department to ensure that these models can continue.

For example, if a service provider were to make available an advice service that uses a flat fee compensation model, if the provider made any "recommendation" that the plan should consider using the service, the provider would apparently be a fiduciary. If any fees associated with the service are paid to the service provider,[63] it would appear this would itself be a prohibited transaction for which there is no available exemption.[64] This means no service provider could market an advice service as part of its plan services package unless it does so for free.

Similarly, suppose that an IRA owner meets with an investment adviser that offers an asset-based advice fee. Because the investment adviser will likely recommend that he be hired, the adviser has made a "recommendation as to a person who is also going to receive a fee" for providing advice. And thus there is an apparent prohibited transaction, even though the compensation is structured precisely to avoid any prohibited transaction concerns.

XI. Committee Members' Significant Concern about the Best Interest Contract Exemption.

The Department has proposed a new and complex exemption, the Best Interest Contract Exemption (BICE), as its solution to the disruption that will be created in the plan and IRA market by the proposal. We think the idea of a principles-based exemption ensuring that anyone who provides advice acts in their client's best interest is the right solution. Unfortunately, we believe the BICE as proposed falls far short of meeting the goal of balancing protecting participants and IRA owners while being workable. The BICE is not workable in its current form, and minor tweaks at the edges are unlikely to make it a workable exemption. (Major changes, of course, could create other unintended consequences that will not be known unless the Department seeks comments on them before the rule is finalized.) The cost of compliance with the exemption means that, even if the most significant concerns are addressed, the BICE is simply not worthwhile economically to provide advice or facilitate rollovers to small accounts. It is for this reason that our comments above have focused on PTE 84-24, because we believe PTE 84-24 is a workable framework to meet the Department's goals.[65]

First, our overall comment is that if the Department decides to maintain the distinction in proposed PTE 84-24 between annuities that are securities and those that are not, then the BICE needs to be vastly simplified to follow the straightforward conditions in PTE 84-24: the adviser

[63] Note that the Department's 408(b)(2) regulation would require disclosure of these fees paid to a recordkeeper, whether they are direct or indirect compensation.

[64] The BICE is aimed at the sale of a security, and thus is not intended for this situation. It is also not clear that, even for large plans, the seller's carve-out would be available, as this is not a bilateral contract.

[65] As noted earlier, one key reason BICE is not suited for annuities is that, by design, it does not address spread revenue that is inherent in any product that provides a guarantee. To take a simple analogy, there is no "cost" for a bank certificate of deposit, as the "cost" is inherent in the difference between the promised interest and what the bank might (but is not guaranteed to) earn on the deposit. The Department appropriately came to the conclusion in connection with the 408b-2 and 404a-5 disclosures that "spread" is not disclosed as a "fee."

must act in the customer's best interest, must not make any misleading statements, and must disclose material conflicts of interests.

Second, the Department's estimates regarding the cost of compliance with the BICE make a number of assumptions that significantly undervalue the costs of the BICE. For example, the Department assumes that a financial institution will only require 60 hours of legal work to comply with the BICE. The proposal requires a multi-business line team of lawyers, and, just based on the proposal, insurance companies and other financial institutions have created large teams of compliance lawyers working exclusively on the proposal since its release. Second, the Department assumes only 100 hours of information technology costs to build the systems to support the BICE. We understand that 100 hours will be needed *simply to scope out the multiple systems that must be amended*. The Department also estimates the financial institutions will send only *two* point of sale disclosures to IRA owners per year, even though the disclosure is required for every transaction in an IRA, and that each disclosure will require *only two minutes* of clerical time to print and mail. All of these estimates significantly understate the costs that Committee members expect.

Third, the BICE presents particular risks and challenges for assisting plans and IRA owners in using products that provide guaranteed lifetime income during retirement. Annuities are not the same as a mutual fund or an individual security. Annuities are more complex to explain to an individual, and they also require more personnel training, *e.g.*, the agent needs to understand the product and when it is appropriate for a customer. The BICE puts significant pressure on *any* differential product compensation. Committee members express deep concern that the likely result under BICE of having to prove in court the reasonableness of any compensation difference between annuity products and other savings vehicles will result in extensive and costly litigation.

The industry *should* be concerned about the litigation risks involved with BICE. The 401(k) industry has been hit with a series of class action lawsuits.[66] Plan sponsors and service providers routinely win these cases, but only after millions of dollars have been spent on litigation costs. The Department itself often intervenes in these cases to argue against their dismissal early in process. Whether or not a particular commission structure for an annuity would "encourage advice that runs counter to the Best Interest of the Retirement Investor" is going to be a facts and circumstances test that insurance companies will need to work out only through very expensive class action litigation. Informally, the Department has said that it is only concerned with "gross violations and outliers." That may be true, but class action plaintiffs' lawyers will not have such noble intentions, which means providers must either price the risk into the product or exit the business entirely.

Fourth, Committee members have deep concern about Section VI of the BICE, which requires the Financial Institution and the Adviser to offer a very broad range of asset classes. It

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[66] Nearly 40 lawsuits have been brought relating to 401(k) fees, with class action plaintiff firms having little success but being able to secure just enough in settlements to continue the campaign. *See* http://www.groom.com/media/publication/1481_401k_fee_cases_detailed_chart_January_2015.pdf.

is unclear as an initial matter what this means for the sale of annuities. Variable annuities can offer multiple asset classes with respect to the funds available for allocation in the contract's separate account (and might also offer one or more general account guaranteed investment). The annuity features of the contract might be viewed as an "asset class" but are more properly understood as a lifetime income option. In addition, we are concerned that many agents and brokers focus on a particular product or set of similar products. In fact, many develop an expertise in a particular product like an annuity that they are comfortable explaining. The BICE presents a number of challenges in this regard. For example, Section IV of the BICE requires the "Financial Institution" to make available all asset classes, with a narrow exception subject to a number of conditions. We think the conditions in Section IV are unnecessary, because the adviser is already subject to the conditions of Section 404 of ERISA or the "Impartial Conduct Standards." In addition, under longstanding Department guidance, it is perfectly acceptable for a fiduciary to be limited in the asset classes to which the fiduciary's authority applies.[67]

Fifth, the disclosures required by the BICE are unnecessary in light of the carefully considered disclosures required under federal and state law. For example, variable annuities sold in connection with IRAs must be accompanied by a prospectus whose required content has been carefully crafted by the SEC over the years to focus on those features and costs of the annuity that are most material to an investor.[68] The prospectus, which the SEC calls the "most important source of information about a variable annuity's investment options," contains detailed information about the product features, the fees and charges, and the investments.[69] Most importantly, the prospectus is designed to allow comparability among variable annuities by standardizing the disclosure. We are aware of no evidence that the disclosures required by the SEC are *insufficient.* Accordingly, if the BICE is retained, we would recommend that the disclosures in Section III of the BICE be deemed satisfied if the retirement investor receives the disclosures required by federal or state law with respect to the annuity.[70] In any event, as

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[67] DOL Reg. § 2550.404a-1(b)(1)(i).

[68] Federal securities laws require that a prospectus disclose all material facts and risks and the issuer undertakes strict fraud liability for any material misleading statements and any material omissions in the prospectus.

[69] Securities and Exchange Commission, Office of Investor Education and Advocacy, *Variable Annuities, What You Should Know, available at*: http://investor.gov/sites/default/files/Variable%20Annuities.pdf.

[70] The NAIC has promulgated the Annuity Disclosure Model Regulation (Model 245) for the states to adopt, reject, and/or revise at their discretion. All but twenty-one states have adopted a previous or current version of the model regulation. The NAIC Annuity Disclosure Model Regulation requires that a disclosure document and Buyer's Guide be provided at or before the time of application in the case of a face-to-face meeting; otherwise, these documents must be sent within five days of receipt of the application by the insurer. The model rules require the following minimum disclosures:

- The name of the product, the company product name (if different), the form number, and the fact that the product is an annuity;
- The insurer's legal name, physical address, website, and telephone number;
- A description of the contract and its benefits (emphasizing its long-term nature), including an explanation of:
  - o The guaranteed and non-guaranteed elements of the contract, the limitations of the contract, and the elements used to determined indexed based interest (e.g. participation rates, caps or spread) and how those elements operate,

discussed above, the Department should coordinate with the SEC staff regarding the inconsistencies in the BICE disclosures and the requirements of the federal securities laws requiring standardized mutual fund and variable annuity fee tables; FINRA public communication rules; and the requirements applying to adviser advertisements under the Advisers Act.[71]

Sixth, we know that the Department has heard, and will continue to hear, numerous concerns about the requirement in the BICE to enter into a contract before any discussion begins. This requirement will be impossible to satisfy in many circumstances. We think that even where the circumstances might permit it, very few individuals will want to sign a contract simply to begin conversations with an agent or broker or to hear a sales presentation. (Many individuals may want to talk to multiple financial advisors before making a decision.) Finally, we think the requirement that the contract be "tri-party" will be unworkable except in the very narrow situation in which the individual advisor will be working with the client in perpetuity. More often, an IRA owner will have interactions with multiple individuals over time.[72]

Seventh, as noted earlier with respect to PTE 84-24, Committee members are concerned with how the Department has described the "best interest" standard because the Department has added a *new* element, not contained in ERISA section 404, requiring that the Adviser act "without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party."

- The initial crediting rate and how interest is determined (this includes any bonus or introductory portion, the duration of the rate, and the fact that rates change and are not guaranteed),
- Periodic options on a guaranteed and non-guaranteed basis,
- Value reductions caused by withdrawals from or surrender of the contract,
- How values within the contract can be accessed,
- The death benefit (if any) and how it will be calculated,
- A summary of the federal tax status of the contract and any penalties applicable on withdrawal, and
- The impact of any rider;

- The specific dollar amount or percentage of charges and fees with an explanation of how they apply; and
- Information about the current guaranteed rate or indexed crediting rate formula that contains a clear notice that the rate is subject to change.

All terms must be defined in a language that a typical person to whom the disclosure is directed would understand. The model regulation also provides the standard for annuity illustrations, reporting requirements for annuities in the payout period that include non-guaranteed elements and deferred annuities during the accumulation period.

[71] A related point is that the extensive reporting requirements in Section IX of BICE are excessive in light of the detailed reporting financial institutions already provide to their primary regulators.

[72] We recommend that the contract requirement be removed. However, if the Department does not agree, then the contract should be required on or before the transaction that would otherwise trigger a prohibited transaction (such as the payment of compensation to the adviser or the purchase of a security or other property) occurs.

<u>Eighth</u>, the BICE imposes a new burden to determine the reasonableness of one's own compensation. This is a perhaps subtle but important point. Many statutory and class exemptions include a condition requiring "reasonable" compensation, including ERISA section 408(b)(2). But the longstanding view has been that a service provider is not responsible to determine the reasonableness of the provider's own compensation. Generally, under current law, we expect that a service provider will *disclose* the compensation to be received, and the independent fiduciary makes the decision. This is at the heart of the Department's new disclosure regulation under ERISA section 408(b)(2). But the BICE imposes a different formulation, which places a party relying on the exemption in a precarious position. Section II(c)(2) provides that the Adviser and Financial Institution must affirmatively agree that no Asset will be recommended unless the total compensation to be received is reasonable. Besides being a condition for relief, this agreement is enforceable as a contractual matter, which means the service provider must be able to demonstrate compliance with the condition, through some yet-to-be-determined benchmarking. We are not sure how an insurance company could benchmark its own compensation inherent in the product, particularly the spread between a guaranteed return in the contract and the return of the insurance company's general account. Further, in the context of an IRA, the only independent fiduciary is the IRA owner, making this "reasonableness" condition more difficult if challenged.

The Department needs to make very clear that the *reasonableness* of compensation for a product or service is tied to that product or service. The comparison should be to other products with similar features. Put another way, a portfolio consisting solely of index funds with no guarantee has lower fees than a variable annuity because having a ***guarantee costs more than not having a guarantee***. We are very concerned that, unless the Department provides clear guidance, insurers and other financial service firms will be left open to frivolous litigation that attempts to make inappropriate comparisons to products that do not provide any guarantees.

<u>Ninth</u>, regulatory coordination is necessary to determine whether an affirmative statement as to fiduciary status compromises reliance on the broker-dealer exclusion in the Advisers Act. The Department intends that insurance agents or brokers that are not registered investment advisers under the Investment Advisers Act, but who make a recommendation that will trigger fiduciary status under the proposal, will need to comply with the BICE. These insurance agents and brokers are *not* providing advisory services, but rather recommendations incidental to the sale of a security or insurance contract. The BICE requires that the insurance agent or broker agree by contract to a higher duty of care than they have under current law. This includes:

- Contractually agreeing to provide advice that "reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party."

- Affirmatively warranting to comply with federal and state laws that *relate to the provision of investment advice.*

- Making a specific finding that the investments that will be offered represent all the asset classes that the investor may need.

We are very concerned that the very act of meeting the requirements of the BICE ***essentially requires the insurance agent or broker to offer a service that triggers the need to register as an investment adviser with the SEC***. The SEC will, by necessity, need to address this issue, and the need to resolve it before insurance agents and brokers come into compliance with the BICE requires additional time before the proposal can be finalized and effective.

Tenth, we think that the mandated website disclosure in Section III(c) is unnecessary and excessive and should be deleted. This disclosure would require a massive amount of information regarding "the direct and indirect material compensation payable to the Adviser, Financial Institution and any Affiliate for services provided in connection with each Asset (or, if uniform across a class of Assets, the class of Assets) that a Plan, participant or beneficiary account, or an IRA is able to purchase, hold, or sell through the Adviser or Financial Institution, and that a Plan, participant or beneficiary account, or an IRA has purchased, held, or sold within the last 365 days." The system required to build such a website is not possible in five years, let alone eight months. Because the requirement includes disclosure of adviser compensation, providers who sell through multiple advisers would presumably need one website for each of their advisers, which could number in the thousands. And it would appear to have little purpose in actually helping a retirement saver make an informed decision.

Eleventh, while we appreciate that the Department has included annuities in the "Assets" that are covered by the BICE, as a conceptual matter we think it is inappropriate to limit the assets that can be recommended under BICE. Congress has quite deliberately provided that plans and IRAs can invest in any security or other property, with limited exceptions Congress has laid out.[73] In addition, since the adviser subject to BICE will be a fiduciary, it inappropriately constrains what the adviser can recommend. Finally, we think it is not consistent with the Department's goal of making BICE a "principles-based" exception to limit the assets available under the exemption.

Twelfth, we recommend that the Department delete Section IX of the BICE. Section IX provides for detailed data retention and reporting regarding individual customers and states that the Department may post this data on its website. This is a massive data retention requirement, and the data request will be inconsistent and misleading. Further, the Department has not shown, nor could it, that such a massive record retention requirement is consistent with ERISA's standards for the grant of an exemption. For example, we don't believe it is administratively feasible, nor do we see how it could be in the interest of participants or protective of their rights.

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[73] With respect to IRAs, Congress provided only two prohibitions: life insurance and certain collectibles. Code section 408(a)(3), (m). As the Department knows, Congress decided during the consideration of ERISA to avoid the concept of "legal lists" that constrained trustees under trust law.

Thirteenth, as noted earlier, clarification is needed with respect to which institution is considered the "Financial Institution" for purposes of the contract required by BICE. To return to our earlier example: Imagine a large financial services institution that has an affiliated registered investment adviser (RIA), an affiliated retail broker-dealer (BD), and an affiliated licensed insurance agency (IA). BD and IA enter into selling agreements with various insurance companies, to make the products of those insurance companies available to their representatives (who are also registered Investment Adviser Representatives of the IA) for sale to the customers of BD. Under state insurance laws, among other requirements, an agent must be "appointed" as an agent by an insurance company to sell insurance products of that particular insurance company. Thus, an individual representative has, in some sense, a relationship with all of these entities that could meet the definition of "Financial Institution." We think two clarifications are appropriate. First, the entities should be able to agree amongst themselves which entity will enter into the contract, but relief should be provided for all parties (to the extent a prohibited transaction might be attributable to any of them). Second, the product manufacturer should not be considered the Financial Institution unless there is no other investment advisory firm, broker-dealer, or insurance agency that employs or otherwise retains the individual as an independent contractor, agent, or registered representative.[74]

XII. An Additional "Low-Fee" Exemption is Inappropriate Without Significant Additional Public Input.

In the preamble to the BICE, the Department asks for comments on whether it should create a separate exemption for "high-quality" and "low-fee" investments. We think it is inappropriate to adopt such an idea at this time. The regulated community does not have enough time to consider the implications of the regulation and exemptions that the Department has already proposed, and cannot meaningfully comment on a separate and vaguely defined exemption. We would urge the Department to instead focus on making the BICE, PTE 84-24, and other exemptions workable so that a streamlined exemption is unnecessary. If the Department wants to pursue this idea, it should do so only after issuing a separate Request for Information.

There are reasons to be very concerned that such an exemption might be very disruptive to the retirement savings of Americans. We are particularly concerned that such an exemption would limit access to and use of lifetime income guarantees. The Department has gone so far as to say that it is currently considering allowing only mutual funds to be recommended under this streamlined exemption. It is hard to imagine any proposal *less consistent* with the statutory scheme Congress envisioned in ERISA, which goes out of its way not to favor one investment structure over another.

We are also deeply concerned that the Department is now considering departing from longstanding emphasis in ERISA and 40 years of guidance on a "reasonable" fee or other

[74] As noted earlier, we do not believe the Department intended that the product manufacturer was to be a fiduciary under the proposal merely because state insurance law requires that the persons that sell its products are required to be "appointed" with the insurance company.

compensation,[75] and instead deciding that certain fees are "low" and some are not. No fee is inherently "low" or "high"—fees are only reasonable or not reasonable in relation to the services or product being purchased. In the retirement savings industry, as with any other product or service, the easiest way to keep fees low is to minimize the services. In that case, sophisticated and wealthy participants and IRA owners who can manage their own assets with minimal assistance will benefit, but anyone who needs help will lose.

The very premise of a "low-fee," "high-quality" exemption available only to mutual funds is further evidence of the concern we expressed earlier, namely that the Department is not appreciating that annuities cost more than mutual funds ***because they provide a guarantee, most importantly a guaranteed lifetime income, that a mutual fund does not and cannot provide.*** Those guarantees have costs. But a retiree who is invested solely in mutual funds faces a cost as well – the risk that she might retire and have those savings depleted unexpectedly by a severe market event, depleted by living longer than expected, or both.

Finally, we would point out that such an exemption would not be available for one of the core retirement savings vehicles that Congress created in 1974 – an individual retirement annuity described in Code section 408(b). Before proceeding with such an exemption, the Department should examine, and seek comment on, the extent to which it would be acting contrary to Congress' intent and would disrupt the balance struck when Congress enacted Title II of ERISA.

XIII. The Need for a Reasonable Period for Compliance and Grandfathering Existing Annuities.

It is hard to imagine a regulation that is more complex, affects more aspects of the retirement industry, or crosses more business lines for service providers. There is no regulation in recent memory with this breadth. Accordingly, an eight month "applicability" period is not workable. We believe that the industry will need three years to implement the changes necessary, and will need more time if the Department does not make the changes to the proposal that we have recommended.[76] Further, we believe that the *immediate* effective date is simply not appropriate, because it immediately creates thousands of new fiduciary interactions that did not exist, and creates an immediate risk of private lawsuits.

We also strongly urge the Department to provide that the proposal does not apply to annuities sold and arrangements entered into prior to the effective date of the regulation. This new regulation imposes significant costs that were not priced into products sold before the date.

[75] A search of ERISA, the Department's regulations, advisory opinions, and exemptions for the term "reasonable" fee or compensation returns so many results it is not useful to cite them all here. But we are not aware of anywhere in the history of ERISA providing special rules for "low-fee" investments or services.

[76] To illustrate the scale of changes that will be required, one Committee member has concluded that a conservative estimate of the company's total implementation cost of bringing systems and programs into compliance with the proposal is more than $110 million, with an additional annual cost of compliance of nearly $25 million. Institutional changes of that magnitude take multiple years to implement.

As the Department is aware, the United Kingdom's ("U.K.") financial services industry regulator, the Financial Conduct Authority ("FCA") (formerly the Financial Services Authority), significantly changed the way financial advisers in the U.K. may be paid by banning all payments (including revenue sharing) from product providers to financial advisers beginning January 1, 2013. Under the FCA's new rules (known as "Retail Distribution Review" or "RDR"), advisers in the U.K. may only be paid through charges that are set out and agreed to by a retail client up front. Despite the differences between the U.K.'s RDR and the Department's proposal, the impact on their respective industries is expected to be similar in requiring dramatic changes to the way U.K. and U.S. financial firms and advisers operate and interact with customers. In recognition of this impact, the FCA provided the U.K. industry ***more than two-and-a-half years*** to comply with the final rules regarding adviser compensation that were published in March 2010. Yet even with a lengthy period for compliance, it has been well documented that a significant portion of the U.K. industry withdrew from providing financial advice to retail clients of moderate means leading up to and following the effective date of the new rules. Because the Department's proposal is in many ways more complex than RDR, we urge the Department to consider the analogous U.K. experience when setting the period for compliance with the Department's final rule.

The BICE includes a limited exception for arrangements providing "compensation in connection with the purchase, sale or holding of an Asset by a Plan, participant or beneficiary account, or an IRA, as a result of the Adviser's and Financial Institution's advice, that occurred prior to the Applicability Date." We appreciate this relief, but it comes with a significant condition – the insurance company or agent cannot have any interaction with the customer after the effective date that might constitute a recommendation. For example, the customer could not be provided any information regarding annuitization options under the contract unless the insurance company is willing to take on the cost and risk associated with PTE 84-24 as amended or the BICE. This creates a perverse incentive not to even respond to an individual's inquiry about the annuity that he or she has purchased. We strongly urge the Department to remove this condition from the exemption for pre-existing transactions.

CONCLUSION

The Committee of Annuity Insurers appreciates this opportunity to comment on the Department's proposed regulation and the new and revised proposed exemptions that are relevant to annuities, particularly PTE 84-24 and the BICE. 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 have explained in our comments (and attached Appendix), annuities are insurance products that are unique in their ability to guarantee lifetime income to individuals whose retirement savings have accumulated in individual account plans and / or IRAs. In addition, many forms of annuity products are able to provide middle-class Americans accumulating retirement savings with investment guarantees that are often unavailable except to large investors or workers in defined benefit plans. Providing these guarantees to workers and retirees – and compensating sales agents for the time and care needed to understand and explain these guarantees – necessarily entails greater costs than does offering an index fund. More importantly, an index fund – no matter how inexpensive it may be – simply does not provide the protections most Americans will need as they prepare for and live in retirement.

As we hope we have made clear in our comments, the Committee fully supports a regulatory regime that requires financial professionals who provide investment advice to act in the best interest of their clients. Unfortunately, however, we believe the Department's current proposal is deeply flawed and unless substantially modified in the manner we have described, will almost certainly reduce access to and use of guaranteed income for life for those who most need it. Federal retirement policy has had many successes in the last 50 years in bringing retirement security to more Americans. Those same policies, however, contain examples of the unintended consequences that can and have flowed from well-purposed laws and regulations. We respectfully submit that if the Department's current proposal is adopted largely as written, it will be remembered in no small part as contributing to the decline of retirement security that life annuity payments provide, and helping only those few Americans who need no assistance in preparing for retirement. This would be a most unfortunate legacy for a Department and an Administration that otherwise have contributed greatly to facilitating access to lifetime income by workers and retirees.

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We appreciate this opportunity to offer input on this proposal. 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

<u>APPENDIX A</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 comprised 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. <u>Basic Annuity Payment Options</u>

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 <u>*traditional fixed life-contingent annuity*</u>, the life insurance company guarantees that the individual will receive regularly-scheduled periodic payments that cannot be outlived. 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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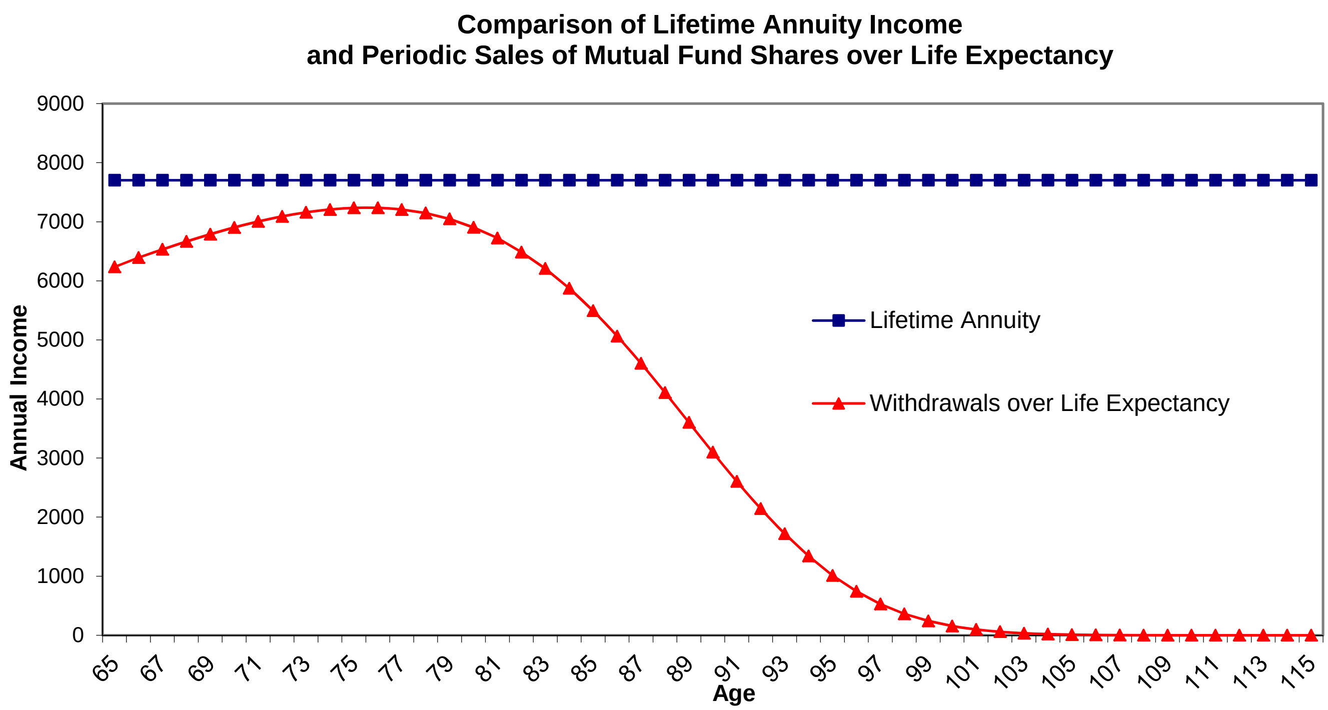
[4] Guaranteed annuity purchase rates may have significant future value. If medical advances result in a material increase in longevity, that increase in longevity would reduce the annuity purchase rates *currently* offered by an insurance company (*i.e.*, each dollar applied to a life-contingent payment 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:



Source: Jeffrey R. Brown, *The New Retirement Challenge* (September 2004). Doctor Brown is Professor of Finance and William G. Karnes Professor of Finance and Director of Center for Business and Public Policy. 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

[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.

life. As the Treasury Department has recognized, "purchasing longevity annuity contracts could 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 our 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

[9] INSURED RETIREMENT INSTITUTE, IRI FACT BOOK, at 43 (2015).

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

[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:

- Longevity and mortality risk. Annuity insurers also face 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.

- Adverse selection risk. 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.

- Investment risk. Annuity insurers face 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 face 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 insurer's asset portfolio market values 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 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

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[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 instead of surrender charges. The amount of the charge 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, either on complete surrender or as discussed below under surrender charges.

    - 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 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. <u>Fees for Additional Insurance Benefits</u>

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 are often 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

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

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
- 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]

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[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.

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

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 a sales agent 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 though the earnings on those premiums. 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, so 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.

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"), 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.[17]

A. <u>Annuity Contract Requirements</u>

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. <u>State Licensing Requirements</u>

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. <u>State Marketing and Sales Requirements</u>

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 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.

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

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.

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