

FEDERATION OF REGULATORY COUNSEL, INC.

THE DIRECTION OF ANNUITY SUITABILITY REGULATION

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The future of annuity regulation is uncertain. Amidst suggestions that the state regulatory framework is not sufficient to protect consumers in annuity transactions, the Securities and Exchange Commission (SEC) published proposed Rules 151A and 12h-7, categorizing fixed indexed annuities as federal securities. Although no one has a crystal ball to predict the future of the SEC proposal, state regulators across the country are working on their own track to enforce existing laws and consider whether additional regulations are necessary. Wisconsin regulators are only one example of the type of activity occurring across the country, but they also play a major role in national reform efforts. It may be helpful, therefore, to consider actions Wisconsin regulators have taken as indications of where state regulation may be headed.

Wisconsin Commissioner Sean Dilweg is Vice Chair of the NAIC's A Committee and Deputy Commissioner Kimberly Shaul is Chair of the A Committee's Suitability of Annuity Sales Working Group. The Working Group is charged with determining whether to revise the standards in the NAIC Suitability in Annuity Transactions Model Regulation. To gain insight into where Commissioner Dilweg and Deputy Commissioner Shaul may steer these efforts, it is helpful to consider Wisconsin's annuity enforcement actions, as well as the work of Wisconsin's own Annuity Sales Supervision Advisory Committee.

ANNUITY ENFORCEMENT ACTIONS

Historically in Wisconsin, annuity enforcement actions focused on agents and unsuitable recommendations. That is no longer true. On June 16, 2008, the Wisconsin Office of the Commissioner of Insurance ("OCI") announced a settlement with Pennsylvania Life Insurance Company ("Penn Life") that was unique in several respects. First, the \$925,000 forfeiture set a record for the agency. Second, the action appeared to be focused on the company's failure to supervise annuity sales. Third, the absence in the order of specific allegations against the company is inconsistent with the normal format of a Wisconsin stipulation and order.

For companies writing annuities, the questions are: What did Penn Life do to warrant the largest forfeiture ever ordered by OCI? What can my company do to avoid a similar enforcement action? These questions are especially important because, although Penn Life is the first large forfeiture against an insurer based on failure to supervise annuity sales, indications are that it will not be the last. An analysis of the Stipulation and Order¹ and the underlying administrative actions against Penn Life agents provides some insight.

Background

In 2003, OCI began its investigation of agents associated with the Premier Marketing Group, a Penn Life affiliate that acts as Penn Life's general agent in Wisconsin. Ultimately, OCI took administrative action against seven of these agents. Based on OCI records, the investigation was initiated over the sale of annuity products. It is clear that OCI became concerned with cross-selling and sales tactics of other products, as well, including long-term care insurance policies, Medicare Advantage, Medicare Part D Plans, and Medicare supplemental policies.

Actions of Penn Life and Penn Life Agents

Because the action against Penn Life settled prior to the issuance of an OCI Notice of Hearing, it was not

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necessary for OCI to publicly identify the allegations against the company. Therefore, the degree of knowledge of the agents' behavior and complicity by the company is not clear from the public record. However, OCI maintains that the question is not whether the company knowingly permitted the illegal acts of its agents, but rather, whether the company had taken proactive steps to prevent violations.

The agents' actions were contested through the administrative hearing process with appeal to Wisconsin circuit court. Penn Life agents were found to have violated Wisconsin laws related to annuity suitability, misrepresentation and home solicitation. Examples of agent behavior include the following:

- Over a one-and-one-half year period beginning October 3, 2003, Penn Life agents sold a 75 year-old woman a nursing home policy; two level premium whole life policies; six flexible premium deferred annuities; and three single premium interest sensitive whole life policies. The majority of these policies were either canceled by the insured or lapsed. In March of 2004, the customer requested that Penn Life cancel all pending policies, complaining about the negative financial impact of the sales and requested that Penn Life agents not contact her again. Instead of honoring this request, Penn Life requested that an agent contact the customer in an attempt to conserve the business. Agents sold five policies to the customer after this date. Ultimately, the transactions resulted in surrender penalties of more than \$30,000 and significant tax consequences to the insured.²
- OCI alleged unsuitable sales and misrepresentation in each of the agent actions, with allegations of agents' misleading or unfounded assertions, purporting to have knowledge they lacked, failing to exercise reasonable care and recommending products that did not meet the consumer's objectives. Many of the recommendations resulted in customers incurring significant surrender fees.³
- In another case, the OCI alleged that the agent visited an elderly woman, telling her that he was responding to a prepaid mailer card requesting information about Medicare changes. The agent indicated that he was there to discuss Medicare changes, but once inside the home, he began to ask about her financial status. Contrary to Wisconsin law on home sales,⁴ he did not identify himself as an agent until after he obtained her signature on annuity application documents.⁵ According to OCI, agents were trained to use a "one call close method" to obtain a sale on the first visit.⁶
- In other cases, the OCI alleged that the agents ignored consumers' decisions to provide power of attorney to a family member. In one instance, the customer was living in an assisted living facility. He and his father indicated to the agent that he was not mentally capable of making financial decisions and requested that all business inquiries be directed to his father. Ignoring these wishes, the agent had the customer sign documents disbursing funds from his annuity and attempted to transfer a certificate of deposit into a Penn Life annuity.⁷ Similarly, OCI alleged two Penn Life agents were informed by a customer, who was legally blind and could not read documents, that she wished to consult her nephews about any financial decisions. One of her nephews had power of attorney. OCI further alleged that the agents, ignoring her expressed wishes, convinced the customer to let them drive her to the bank. One agent accompanied her inside to assist her in withdrawing her CD's and obtaining a check made out to Pennsylvania Life.⁸

Penn Life Settlement

In addition to the record-setting forfeiture, the settlement order requires Penn Life and its affiliates to maintain a compliance program from July 1, 2008 through 2012. A review of some of the required components of the compliance program is helpful to understand the Wisconsin regulator's perception of what should be included in a supervision system. The order provides that Penn Life's compliance program must include:

- a compliance officer;
- measures and controls that are reasonably designed to ensure that violations of Wisconsin law are promptly identified;
- guidelines and processes for punishing agents for violations of Wisconsin laws;

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- biennial evaluations of the compliance program by a qualified, and nationally recognized, outside auditor;
- creation of an operating budget and administrative plan for operation of the compliance program.⁹

In addition, OCI required Penn Life to implement supervision, monitoring and training measures including the following:

- written compliance procedures and controls;
- compliance training of marketing personnel and agents and annual testing of agents;
- management control and approval of lead cards and marketing material including sales scripts or presentations;
- measures to monitor cross-selling;
- appropriate suitability standards, appropriate standards for inquiry relating to suitability;
- management reports;
- periodic reviews of records reasonably designed to detect violations;
- customer contacts to review transactions reasonably designed to detect violations;
- annual on-site audits of agents and agencies including interviews with agents, review of sales files, etc.;
- contact with selected customers to determine product understanding and agent compliance with regulations;
- written and disseminated standards for personnel and agent discipline; and
- annual Compliance Plans filed with OCI.¹⁰

Components of the order target specific practices OCI identified as problematic. For example, the order specifically addresses advertising that offers information regarding federal Medicare or other government programs, "including but not limited to 'lead cards.'" The order indicates such cards must "state that it is an advertisement for insurance or that it is intended to obtain insurance prospects and prominently state that any material or information offered will be delivered in person by a representative of the insurer, if such is the case." ¹¹

An original review of the order would suggest that one of the more draconian provisions was the requirement that Penn Life cease the sale of annuities in Wisconsin for the period from July 1, 2008 through December 31, 2012. According to OCI, however, annuity products have not been a major line for Penn Life, with most of the annuity sales generated from the one sales office that was the subject of the agent investigations and related enforcement actions.

ANNUITY SALES SUPERVISION ADVISORY COMMITTEE

The Penn Life settlement demonstrates Wisconsin regulators' expectation that companies take proactive steps to prevent agent violations of the annuity suitability regulations. The types of company actions that are expected may be further reflected in the OCI's proposals to the Annuity Sales Supervision Advisory Committee (a Wisconsin regulator/industry committee established by the OCI) created slightly over a year ago.

The Wisconsin Committee was created to consider an administrative rule establishing the minimum supervisory requirements that annuity writers must meet in order to sell annuity products in Wisconsin. Parrett and O'Connell, LLP represents the Wisconsin Council of Life Insurers, and Connie O'Connell serves on this Committee representing the trade association.

The role of this Committee has changed to provide guidance to the NAIC Working Group as it considers changes to the Model Act. Over the course of the past year, the Wisconsin Committee has heard from

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regulators regarding their suitability supervision concerns, company presentations describing their supervision systems and presentations from the Financial Industry Regulatory Authority (FINRA), the Iowa Insurance Department and the Insurance Marketplace Standards Association (IMSA).

The Committee is now discussing the appropriate work product to offer to the NAIC Working Group. WCLI, on behalf of the Wisconsin insurance industry, has suggested that the existing NAIC model should serve as the starting point and that supervision regulation should be based on identifying broad principles rather than mandating a particular supervision system. This recommendation was based on the determination that flexibility is critical given the continued evolution in the market place related to more effective monitoring approaches, changes to product design or changes to distribution systems. Further, this approach would avoid bright line rules that tie regulators' hands and, instead, give regulators more flexibility in addressing issues in the market place.

OCI's original draft, offered at the July 22, 2008 meeting, included a laundry list of very specific supervision, monitoring and training techniques. The standards appeared to reflect the most rigorous elements of the various supervision systems that were presented to the Committee in addition to prescriptive proposals from other forums. The industry expressed concern that the standards inserted regulatory judgment into corporate governance, severely limited the ability to delegate responsibility to third parties, created an unworkable training proposal and required an overly prescriptive and resource-intensive supervision and monitoring system. The following are a few examples of OCI's initial proposal:

- The supervision staff must be a dedicated organization with staffing and budget independent from sale or marketing functions.
- The supervision system must annually report to the audit committee/top management and that the Board of Directors annually review reports related to suitability.
- Staff must interview customers to verify suitability information and understanding of the product. The interviews must include at least all customers over 70.
- If responsibilities are delegated to an unaffiliated insurance agency, the insurer must assure that the agency "has the financial and system capacity to maintain the delegated elements of the Supervision System."
- Insurers must offer mandatory training on every annuity product and that the agent be tested for product knowledge following the training. An agent may not be present at a solicitation prior to completing the training.¹²

WCLI Proposal

The industry, through WCLI, offered a counter proposal for consideration at the August 25th meeting of the Committee. WCLI proposed that the model be updated in the areas of training, disclosure, supervision and monitoring as discussed below. The additions to the model primarily establish principles rather than prescribing particular practices. WCLI also recommended that the NAIC encourage adoption of the model in all states for all ages, adoption of the annuity disclosure model and adoption of the existing replacement model. Further, publication of best practices by regulators would provide guidance to the industry.

In the area of training, WCLI recommended that producers receive two credits of state-approved continuing education regarding the general features and mechanics of annuity products and related suitability considerations. In addition, insurers would be required to make available to producers detailed product information regarding the annuities sold by the producers, and producers would be required to have a comprehensive understanding of the products prior to recommending the purchase or exchange of an annuity. The proposal adds consideration of current and anticipated liquidity needs to the information that must be obtained prior to execution of a purchase or exchange of an annuity. It also requires that the insurer conduct periodic reviews to detect unusual sales patterns and to take corrective action to address such practices.¹³

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OCI was responsive to recommendations that the Advisory Committee produce a consensus document identifying principles updating the NAIC model. The principles are described below under the heading "Consensus Document." However, OCI also determined to refine and submit the more prescriptive concepts for consideration by the NAIC. Although some of the more objectionable provisions were modified, the industry continues to oppose many of the requirements as overly prescriptive, inflexible and inefficient. OCI has agreed to include these objections, and comments from other Committee members, in the document submitted to the NAIC Working Group. Although the work product did not receive endorsement from the Committee, it provides insight into OCI's expected components of a company supervision system.

Consensus Document

The following principles were supported by the Committee:

1. An insurer, general agency or third party shall have written guidelines to reasonably ensure the suitability of annuity sales.
2. Guidance for a suitable sale shall include a liquidity analysis reasonably designed to determine the consumer's current and future need for liquidity.
3. A recommendation of an annuity product shall include a written disclosure to assist in the consumer's understanding of the product being sold.
4. An insurer, general agency or a third party shall have processes and written procedures to identify potentially unsuitable annuity sales.
5. An insurer, general agency or a third party shall have procedures to follow when an unsuitable sale is suspected, including procedures for corrective action.
6. An insurer, general agency or third party shall monitor to prevent, identify and address suitability issues.
An insurer, general agency, or third party shall take corrective action, as appropriate, to address sales practices or patterns resulting in unsuitable sales.
7. NAIC should work to develop uniform continuing education training requirements relating to annuities.
8. Agents recommending annuities must complete state required continuing education training relating to annuities.
9. An insurer, general agency or third party shall make available to producers detailed product information regarding the annuities it sells.¹⁴

CONCLUSION

As some proponents of the SEC fixed annuity proposal allege failure of state insurance regulators to protect consumers in annuity transactions, the reality in states is very different. Wisconsin is only an example of the serious efforts in states to assure consumer protection in the sales of annuities. Wisconsin was the first state to adopt the NAIC model, has taken significant enforcement actions against companies and agents and is committed to strengthening the regulatory framework.

If you would like to receive copies of the referenced documents, please contact either Noreen Parrett (nparrett@parrettoconnell.com) or Connie O'Connell (coconnell@parrettoconnell.com).

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Endnotes

1. *In the Matter of Pennsylvania Life Insurance Company*, Stipulation and Order, Case No. 08-C31326
2. *In the Matter of Shawn P. Henderson*, Petition For and Summary Suspension Order and Cease and Desist Order, Case No. 05-C29711
3. *In the Matter of Kenneth R. Brown*, Stipulation and Order, Case No. 05-C29450; *In the Matter of Lucas J. Brunmeier*, Final Decision, Case No. 05-C29612; *In the Matter of John L. Hammer*, Final Decision, Case No. 05-C29611; *In the Matter of Shawn P. Henderson*, Final Decision, Case No. 06-C30049; *In the Matter of Stephen K. Love*, Final Decision, Case No. 05-C30510; *In the Matter of Richard T. Paetz*, Final Decision, Case No. 04-C29032; *In the Matter of Timothy J. Petrie*, Final Decision, Case No. 05-C29438
4. It is evident from the Penn Life Order and the actions against the agents that a significant OCI concern was the systematic violation of Wisconsin's home solicitation requirements. Wisconsin regulations require that certain disclosures be made at the time of initial contact of a home solicitation, including the agent's name, name of business, fact that insurance is being sold, identity of the insurer and type of insurance being solicited. Wis. Adm. Code § Ins 20.01(4)(a)
5. *In the Matter of Richard T. Paetz, Kenneth R. Brown*, Notice of Hearing, Case Nos. 04-C29032 and 05-C29450, page 2
6. *In the Matter of John L. Hammer*, Final Decision, Case No. 05-C29611 page 6
7. *In the Matter of Richard T. Paetz*, Final Decision, Case No. 04-C29032
8. *In the Matter of Richard T. Paetz*, Final Decision, Case No. 04-C29032
9. *In the Matter of Pennsylvania Life Insurance Company*, Stipulation and Order, Case No. 08-C31326
10. *In the Matter of Pennsylvania Life Insurance Company*, Stipulation and Order, Case No. 08-C31326
11. *In the Matter of Pennsylvania Life Insurance Company*, Stipulation and Order, Case No. 08-C31326
12. Letter from Kim Shaul, Wisconsin Deputy Insurance Commissioner, to Annuity Sales Suitability Committee Members (July 18, 2008)
13. Letter from Connie L. O'Connell, Wisconsin Council of Life Insurers, to Kim Shaul, Wisconsin Deputy Insurance Commissioner (August 13, 2008)
14. "Principle Based Guidelines for consideration in modification of the NAIC Suitability in Annuity Transactions Model Regulation," Wisconsin Annuity Sales Supervision Committee (August 25, 2008).