January 22, 2018

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Senior Health and Life Policy Counsel
National Association of Insurance Commissioners
Executive Headquarters
Hall of the States Building, Suite 700
444 North Capitol Street, N.W.
Washington, DC 20001-1512

Re: Proposed Suitability and Best Interest Standard of Conduct in Annuity Transactions Model Regulation

Dear Ms. Matthews:

The signatories below are writing in response to the National Association of Insurance Commissioners' (NAIC) request for comments on its proposed "Suitability and Best Interest Standard of Conduct in Annuity Transactions Model Regulation." We are all of the view that the proposed rule falls far short of a true fiduciary best interest standard. In fact, it remains weaker than the existing securities law suitability standard, let alone the Department of Labor's (DOL) fiduciary rule, on the crucial issue of managing conflicts. As such, it fails to adequately protect annuities investors from the harmful effects of conflicted advice. It also fails to serve as a model on which a harmonized standard of care for all types of investment accounts could be based. For these reasons, we urge you to withdraw the current proposal so that it can be rewritten to address these serious shortcomings.

Last July, a group of 24 investor and consumer advocates wrote to the NAIC outlining the key components a best interest standard for insurance investments would need to include to benefit consumers and win our support.[1] We concluded our letter with the following warning: "Under no circumstances should NAIC adopt a watered down standard … that gives lip service to best interest but without including the components – especially real limits on conflicts of interest – that are essential to make that standard a reality." Unfortunately, that is precisely what the NAIC has done with this proposal.

The Proposal Does Not Include a Clear, Enforceable Best Interest Standard

The proposal's best interest standard is procedural in nature, requiring the producer to act "with reasonable diligence, care, skill and prudence in a manner that puts the interest of the consumer first and foremost." But it does not make clear what putting "the interest of the consumer first and foremost" actually entails. Specifically, while the definition of best interest is crystal clear on what it does *not* require, it is extremely vague on what it does require. It makes clear, for example, that the producer is not required to recommend the "single 'best' annuity

[1] Comments of NAIC Consumer Representatives and Consumer and Worker Advocates to the NAIC Annuity Suitability Working Group regarding "Best Interest" Amendments to the NAIC Suitability in Annuity Transactions Model Regulation, July 31, 2017, http://bit.ly/2CjafKR.

product available in the marketplace at the time of the annuity transaction." But the proposal does not make equally clear that the producer *should* recommend the best available option, where available options are defined as those the producer has available to recommend within his or her particular business. And, while it makes clear that the producer is not required to recommend "the least expensive annuity product, or the annuity product with the highest stated interest rate or income payout rate, available in the marketplace at the time of the annuity transaction," it does not make equally clear that the producer cannot ignore these factors in determining which of the available options is best for the investor. Without those elements, it is not clear whether or how simply adding the words "best interest" to the existing suitability standard raises the standard of conduct for annuities sales.

The proposal casts further doubts over whether this is a true best interest standard when it specifies that compliance with FINRA's best interest standard would satisfy the rule because FINRA has no such standard. To the degree that FINRA discusses brokers' obligation to act in customers' best interests, it is in the form of guidance regarding compliance with FINRA's suitability standard. If the reference in the proposal to FINRA's best interest standard is really just a reference to the existing FINRA suitability standard, NAIC must drop the pretense that it has raised its applicable standard. It is simply rebranding the existing suitability standard as a best interest standard—an entirely unacceptable outcome. If the reference is *not* to FINRA's existing suitability standard, NAIC must make clear what it is referring to when it cites FINRA's best interest standard and whether compliance with the suitability standard under FINRA rules would satisfy the proposed standard for annuities sales.

The definition and application of the proposed best interest standard has other serious shortcomings that reinforce our view that it would create a best interest standard in name only. One is that the recommendation is measured not against what an impartial expert operating in like circumstances would conclude, but by what the producer "believes … is in the best interest of the consumer." This suggests that the best interest standard would be satisfied as long as the producer follows a reasonable process and claims to believe the resulting recommendation is in the customer's best interests, regardless of how far outside the norms of accepted practice that recommendation might be. That is not a true best interest standard.

Also, while the proposal's requirement that the producer or insurer make a record of any recommendation "and the basis or bases of the recommendation" is a step in the right direction, it does not go nearly far enough. The proposal needs to clearly and explicitly require documentation of the facts, assumptions, and analysis that led the producer to conclude that the particular annuity recommended is the best of the available options for the customer, taking into account costs, performance, liquidity, and other relevant product features, as well as a customer's particular circumstances. Without such documentation, this recordkeeping procedure is all too likely to devolve into a check-the-box exercise, and regulators who seek to enforce the rule and insurers responsible for supervising the recommendations will find it difficult, if not impossible, to determine whether the best interest standard has been met. The supervision requirements included in Section H (1)(d) and (e), while modestly beneficial, are not sufficiently clear and specific to ensure compliance.

To rectify these short-comings, the proposal should be revised:

- to clearly state that producers operating under a best interest standard must recommend, from among the products they have available to recommend, the one that is best for the investor;
- to make clear that the producer must weigh such factors as product costs, interest rates or income payout rates, and other relevant product features in determining which option is best for the investor;
- to measure compliance based, not merely on what the producer "believes" is in the customer's best interest, but what an impartial expert operating under like circumstances would deem to be in the customer's best interests; and
- to require that the producer clearly document the facts, assumptions, and analysis that led the producer to conclude that the recommended annuity represents the best available option for the investor.

The Proposal Does Not Adequately Address Conflicts of Interest

All of these short-comings in the definition and application of the best interest standard are magnified by the proposal's failure to take any meaningful steps to rein in producers' financial incentives to act in ways that are contrary to customers' best interests. The fact is that financial compensation practices are tolerated in the insurance annuities market that are inconsistent with a true best interest standard. Indeed, some practices that are legal in the insurance market, such as product-specific sales contests, were prohibited under FINRA's rules long before the DOL conflict of interest rule was adopted. The proposal does nothing to rein in such practices, even though extensive research has shown that conflicts affect financial professionals' recommendations and do so in ways that are harmful to investors. For example, authors of a 2015 RAND Corporation report that compiles research on conflicts of interest cite several studies that "support the view that acting on potential conflicts of interest is fairly widespread and is costly to investors."[2]

In recognition of the importance of better aligning incentives to support a best interest standard, the investor and consumer advocates who wrote to NAIC in July urged the association to "recognize the role of the producer compensation structure in aligning or misaligning insurer and producer interest with the best interest of consumers." We called on NAIC to include meaningful restrictions on conflicts of interest. We noted, moreover, that while some types of conflicts can reasonably be addressed through disclosure – such as the fact that the producer is paid through commissions or sells from a limited menu of products – others cannot. Conflicts that cannot be adequately addressed through disclosure alone are those where "the conflicts of interest are so great – and reflect sufficiently powerful market forces – that disclosure, no matter how well crafted, is insufficient to protect the consumer." These include practices – "such as paying differential compensation or using sales quotas or contests to promote the sale of particular products – that encourage recommendations based on factors other than the consumers' best interest."

[2] Jeremy Burke, Angela A. Hung, Jack W. Clift, Steven Garber, and Joanne K. Yoong, Impacts of Conflicts of Interest in the Financial Services Industry, RAND Working Paper, August 2014, http://bit.ly/2w8gzOt.

Disappointingly, the proposal does nothing concrete to rein in harmful incentives that work against a best interest standard. It simply directs producers not to act on those conflicts. Experience tells us, however, that directing producers not to base their recommendations on their own financial interests, while leaving in place incentives that encourage them to do so, will not significantly reduce the harmful impact of conflicts. This would be true, even if the rule imposed a clear, enforceable best interest standard and required detailed documentation of the basis on which the producer concluded that the recommended annuity was the best available option for the investor. But, as we discuss above, the rule does neither of those things.

Instead of reining in conflicts, the proposal requires only that conflicts be disclosed, an approach that has been shown to be ineffective in protecting investors. One reason conflict disclosure is ineffective is that investors typically lack the financial expertise to determine whether or to what degree the advice they receive has been negatively affected by conflicts. This is particularly true in the case of annuities which tend to be among the more complex and opaque products recommended to average, financially unsophisticated retail investors. In such circumstances, the consumer is highly reliant on the producer to understand the product being sold and cannot independently assess whether the recommendation has been inappropriately affected by conflicts, even where the consumer reads and understands the disclosures. A 2016 RAND Corporation study found, for example, that "many consumers fail to adjust their behavior sufficiently, if at all" when conflicts are disclosed.[3]

Other research suggests that conflict of interest disclosures are not just ineffective, they can actually have a harmful impact on consumers. For example, financial professionals who disclose conflicts may feel that disclosure gives them "moral license" to engage in self-interested behavior and thus give more biased advice.[4] At the same time, investors may feel increased pressure to follow the recommendations where conflicts have been disclosed, motivated in part by their "reluctance to appear unwilling to help the advisors once the advisors' interests were publicly disclosed."[5] In short, by failing to rein in conflicts and requiring only that conflicts be disclosed, the proposal could do more harm than good.

To rectify these shortcomings, the proposal should be revised:

- to draw a clear distinction between conflicts of interest that can be addressed through disclosure and those which cannot;
- to limit or ban those practices, such as product-specific sales contests and significant compensation differentials, that encourage recommendations based on the producer's own financial interests rather than the customer's best interests; and

[3] Angela A. Hung, Min Gong, and Jeremy Burke, Effective Disclosures in Financial Decisionmaking, RAND Research Report, July 2015, http://bit.ly/2wbYOO0.
[4] Daylian M. Cain, George Loewenstein, and Don A. Moore, "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest," Journal of Legal Studies, vol. 34 (January 2005), http://bit.ly/2f7RUHm.
[5] George Loewenstein, Daylian M. Cain, and Sunita Sah, The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest, American Economic Review: Papers and Proceedings 2011, 101:3, 423–428, http://bit.ly/2eOGd8i.

- to strengthen the requirements for conflicts that are addressed through disclosure to ensure that the disclosures are clear and timely and present the relevant information in a way that is accessible and understandable to the typical annuities investor.

The Proposal Does Not Apply to All Insurance Products with Investment Components

By its terms, this proposal applies only to annuity transactions, thereby excluding from coverage many other types of insurance products with investment components that are marketed and sold to investors. As a result, investors would not receive the protections they need when they receive recommendations to purchase these products even though many of them are particularly complex, opaque, costly, and beset by conflicts of interest. The same standard of care – best interest of the consumer – is clearly as appropriate for investment-type life insurance – for example, indexed universal life – as it is for annuity products. Accordingly, the application of an enhanced standard should be broadened to investment-type life insurance products. A uniform standard of care across all types of investment products means both consistent consumer protection and a level regulatory framework preventing one type of investment product from regulatory arbitrage.

Conclusion

Absent the changes outlined here to strengthen the definition of best interest, its application, and the treatment of conflicts of interest, the proposal will fall well short of what is needed to protect investors from the harmful impact of conflicts of interest that pervade the annuities market. Since the DOL could not reasonably rely on such a rule to satisfy compliance with fiduciary standards under ERISA and the Tax Code, the proposal would also fail to meet the stated goal of promoting a harmonized standard across all types of investment accounts, something all stakeholders claim to support. For these reasons, investors would be best served if the NAIC withdrew the current proposal in order to address its serious shortcomings and to arrive at an approach that is consistent with the higher standards set by DOL and soon, we hope, by the SEC.

Thank you for considering our comments. We look forward to working with you to develop a true best interest standard for insurance investments that will benefit both investors and those providers who are prepared to compete for business based on the quality of their products and services.

Respectfully submitted,

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Birny Birnbaum, Center for Economic Justice and NAIC Consumer Representative
Brendan Bridgeland, NAIC Consumer Representative
Bonnie Burns, NAIC Consumer Representative
Jesse O'Brien, NAIC Consumer Representative

AFL-CIO
Americans for Financial Reform
Better Markets

Center for Economic Justice
Consumer Action
Consumer Federation of America
Economic Policy Institute
National Consumers League
National Employment Law Project
Pension Rights Center
UnidosUS
U.S. PIRG
Woodstock Institute