INDEXED ANNUITY
LEADERSHIP COUNCIL

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Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Avenue N.W.
Washington, D.C. 20210

Subject: **Examination of Final Fiduciary Rule Pursuant to the President's Memorandum to the Secretary of Labor, dated February 3, 2017 (RIN 1210-AB79)**

The Indexed Annuity Leadership Council (IALC) appreciates the opportunity to comment on the Department of Labor's examination of whether the final fiduciary rule (Final Rule) and the related prohibited transaction exemptions (PTEs) under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (Code) published in the Federal Register on April 8, 2016 may adversely affect the ability of Americans to access retirement information and financial advice. As the Department is aware, the IALC has brought a legal challenge to the Final Rule's treatment of fixed indexed annuities (FIAs), including because the Department lacks statutory authority under ERISA and the Code to regulate one-time annuity sales as fiduciary transactions and because the Department failed to demonstrate the need for additional federal regulation of these transactions given the robust consumer protections that already exist under state law. The IALC stands by these positions and incorporates by reference its legal briefs, which are attached hereto as Exhibits A and B[1]. The IALC submits this letter to respond to the issues raised by the President's Memorandum.

The IALC is a consortium of life insurance companies[2] that offer FIAs. The IALC was established in 2011 with a mission to educate the public (including regulators) about the benefits of FIAs, which offer principal protection and a predictable, guaranteed retirement income, and can contribute balance to retirement savers' long-term financial plans. Today there are more than $330 billion in FIAs outstanding.[3] The majority of FIAs are purchased

[1] Specifically, IALC incorporates by reference the arguments and showings made in sections I and II.A of its opening brief and section I and II.A of its reply brief.
[2] Allianz Life Insurance Company of North America, American Equity Investment Life Insurance Company®, Athene USA, Midland National Life Insurance Company, National Life Group®, North American Company for Life and Health
[3] Secure Retirement Institute, *U.S. Individual Annuity Yearbook (2015 Data)* at p. 46

by retirement savers in transactions that would be covered by the Final Rule and related PTEs.

IALC member companies believe it is critically important for retirement savers to have access to a host of financial products so that a financial adviser can recommend a retirement savings strategy that serves each client's best interest. In certain circumstances, an FIA is the product that best serves a client's interest and therefore maintaining access to these annuity products promotes the Department's goal of protecting retirement savers. Annuities are already subject to extensive state insurance regulation. The Department's Final Rule and PTE structure, however, add unnecessary cost and complexity to the existing scheme of annuity regulation—costs and complexity that will ultimately harm retirement savers. It is vitally important, therefore, that the Department modify its approach to ensure that its regulatory framework in fact protects the best interest of retirement savers.

I. BACKGROUND ON FIXED ANNUITIES

There are two types of deferred annuities – fixed and variable. Like any financial product, each has a role in addressing a consumer's financial planning needs. Some annuity providers offer both, while others issue either fixed or variable products. In either case, as insurance contracts, state insurance regulators approve their terms, and the products are subject to significant and ongoing regulatory oversight. This oversight extends to sales practices as discussed below.

A. In General

Fixed annuities, including FIAs, have been used by consumers for many years as part of a well-structured financial plan and as a way to provide guaranteed income for life. The shift by employers away from defined benefit pension plans has heightened the importance of educating consumers about the benefits of fixed annuities that can help ensure that they have sufficient funds to last throughout their retirement years. Fixed annuities can play an important role in achieving that objective because they offer guaranteed income and protection from market volatility. Of course, that does not mean that fixed annuities are the only product that should be included in an individual's financial plan. Rather, they act as an important instrument to protect principal and insure against longevity risk that should be considered as part of sound retirement planning.

Fixed annuities offer protection against market loss as the insurance company assumes the market risk. In other words, there is no risk of loss of principal and any earnings credited to the policy are guaranteed and cannot be lost or reduced in future periods (so long as the owner does not surrender the contract prematurely). Earnings can be credited based on a periodically declared rate, a multi-year guaranteed rate, or a rate established based on a formula that references a market index (a fixed index annuity).

Regardless of the crediting method, a fixed annuity contract's premium is not invested in a separate account or specific investment, but rather is supported by the general account of the insurance company. In the case of an FIA the index is only used to compute interest earnings credited to the policy; there is no actual investment by the policyholder or the insurance company in the financial instruments that comprise the particular index. A typical FIA allows the policyholder to elect to switch the chosen index or computation method from year to year, or alternatively to select a fixed rate for the year. FIAs were developed to offer the potential to earn more interest than a fixed annuity. **<u>The only difference among these fixed annuity products is the method for determining the interest earnings that are credited to the policy.</u>**

The issuers of fixed annuities do not assess sales charges on the policyholders at the time of issuance of the policy or at any other time. These products are regulated as insurance under state insurance law, protected by state guaranty funds, and are exempt securities under section 3(a)(8) of the Securities Act of 1933. Finally, only state licensed insurance agents can sell fixed annuities.

B. Surrender Charges

Under state insurance laws, a policyholder is offered a free look period: a period of time ranging from 10 to 30 days depending upon the applicable state insurance law, when the policyholder has the right to return the policy for a full refund. Once the policy is in effect the policyholder accrues interest yearly, but initially does not have access to the full account value of the policy. Specifically, a policyholder is charged a surrender charge, or a percent of the contract value, in the event that he or she decides to cash-in the policy early. Surrender charge periods and applicable surrender charges vary from insurer-to-insurer and vary amongst products. Surrender charges are generally reduced each year until they are eliminated. Most products sold today have a surrender charge period of ten years or less and a surrender charge of ten percent or less. Surrender charges are an important part of a fixed annuity contract as they protect the insurance company from losses due to early terminations and allow the insurance company to make longer-term investments thereby providing higher interest rates to policyholders.

The surrender charges are normally waived in a number of situations – for example, to satisfy required minimum distribution (RMD) requirements under federal pension law or in the event of death. Given the substantial percentage of sales of FIAs to Individual Retirement Accounts (IRAs), waiving surrender charges to allow for penalty-free withdrawals to comply with RMD requirements is an important consumer protection feature. In addition, most policies allow a percentage of the contract value to be withdrawn each year after the first year without penalty.

C. Suitability

Because annuities are intended to be held long-term and surrender charges could be imposed under the terms of the policy if terminated early, it is important for the policyholder to demonstrate that he or she has sufficient liquid assets at the time of purchase to reduce the likelihood the policyholder will need to terminate the policy prematurely. State insurance laws require the insurance agent selling the policy, and subsequently the insurance company issuing the policy, to review detailed financial and other data to determine the policy is suitable for the consumer – with emphasis on the consumer's liquidity needs. The National Association of Insurance Commissioners (NAIC) significantly strengthened its model suitability regulation in April 2010 ("Suitability in Annuity Transactions Model Regulation #275"), which today has been adopted by 39 states and the District of Columbia, and as of March 31, 2017 is under active consideration in 3 more states (Model Regulation). But even that statistic understates the actual impact of this Model Regulation. For example, (1) the industry has embraced the Model Regulation – virtually all insurance companies selling fixed annuities comply with the Model Regulation on a nationwide basis; (2) states where insurance companies are domiciled have been active in adopting the Model Regulation making its reach extend beyond the adopting states; and (3) Congress has required compliance with the Model Regulation for companies wishing to avail themselves of a federal securities law safe-harbor exemption for FIAs.[4]

D. Additional Optional Features

Fixed annuity policies also offer consumers a variety of liquidity options and riders that can be added to the policy. Options include: (i) annual penalty-free withdrawals of up to ten percent of the value of the policy; (ii) the ability to annuitize and receive a stream of payments for life or a specified period; (iii) nursing home riders which permit increased penalty-free withdrawals if the policyholder enters a nursing home; and (iv) terminal illness riders which permit penalty-free withdrawals of some or all of the policy value if the policyholder becomes terminally ill. Lifetime income benefit riders are also available which guarantee a lifetime income the policyholder cannot outlive. The lifetime income benefit rider is an alternative to annuitizing the policy where the income payments are lower in exchange for increased flexibility to access the account value. Lifetime income benefit riders can have additional options including enhanced death benefits that provide enhanced payments to the beneficiary and wellbeing riders that provide increased lifetime income benefits to the policyholder in the event the policyholder is unable to perform a certain number of activities of daily living.

E. Distribution Channels

While the largest sales channel for fixed annuities is independent insurance agents (63% of 2015 sales)[5], a significant number are also sold through career agents, banks, broker-dealers, and registered investment advisors. Finally, and most importantly for this discussion, a majority of fixed annuities (over 62%) are sold to IRAs. [6]

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[4] Section 989J of the Wall Street Reform and Consumer Protection Act, Pub. L. No. 11-203, 124 Stat. 1376 (2010).
[5] *Yearbook at p.11*
[6] *Yearbook at p. 41*

F. Market Share

In recent years FIAs have become one of the most popular fixed annuity products. According to Wink's Sales & Market Report, 4th Quarter 2016, FIA sales composed 60% of the total fixed deferred annuity sales for the 2016 calendar year. FIA sales in 2016 eclipsed their prior year record by nearly 10% -- the eighth consecutive year of growth.

G. Conclusion

In sum, fixed annuities, including FIAs, offer an important tool in retirement planning to protect against longevity risk – the risk that a person outlives his or her assets. The benefit of fixed annuities was recognized recently by the Department of Treasury when it adopted regulations making it easier to hold these products in an IRA or pension plan. These so-called Qualified Longevity Annuity Contract regulations eased the minimum distribution requirements to prevent IRA owners and pension plan participants from having to prematurely surrender their fixed annuity policies or face penalties. Because FIAs respond to retirement savers' needs, they have become the fastest growing portion of the fixed annuity market and represent a majority of the fixed annuities now being sold annually.

II. IMPACT OF FINAL FIDUCIARY RULE AND RELATED PTEs

The Department has requested public comment on questions raised in the Presidential Memorandum to the Secretary of Labor dated February 3, 2017. In many cases the Final Rule and its related PTEs will harm retirement savers by reducing access to financial products that serve their best interest. Specifically, the Final Rule if implemented will undermine the ability of many retirement savers, especially those with modest retirement savings, to access retirement advice to include FIAs in their financial plan. We urge the Department to consider the following adverse impacts and their costs on retirement savers as it considers whether to extend the compliance date further and address the Final Rule's defects.

A. Best Interest Contract Exemption

The proposed regulation published on April 15, 2015, treated all fixed annuities similarly and allowed insurance agents selling FIAs to continue relying on PTE 84-24[7]. However, the Final Rule excluded FIAs from PTE 84-24 and instead makes the Best Interest Contract Exemption (BICE) the only applicable PTE that an independent insurance agent selling an FIA may rely on to avoid a prohibited transaction. However, BICE, while defective in many respects not discussed herein, was designed to address sales of securities products distributed through broker-dealers and registered investment advisors (RIAs), not independent insurance agents.

[7] 80 Fed. Reg. 22011

The majority of FIAs are sold by independent insurance agents who work through independent marketing organizations (IMOs)[8]. IALC members, like other insurance companies, frequently contract with IMOs to distribute their products through an IMO's independent insurance agents. These IMOs and their insurance agents typically sell annuity products offered by more than one insurance company. While some IMOs may have a broker-dealer or RIA related entity, the vast majority of independent insurance agents offering FIAs are not licensed to sell securities products.

BICE requires a financial institution to sign a contract with the annuity purchaser obligating it to be a fiduciary along with the insurance agent offering the financial advice. BICE requires the contract to include specific terms and conditions, including that the financial institution accepts full liability for recommendations made by the independent insurance agent. Under BICE, when an FIA is sold by an independent insurance agent who is not associated with a broker-dealer, RIA, or bank, only the insurance company can qualify as a financial institution; IMOs are explicitly prevented from serving as a financial institution for this purpose.[9] Thus, in order to avoid a prohibited transaction an independent insurance agent when offering retirement advice to purchase an FIA is required to have an insurance company sign a BICE contract. However, signing such a contract exposes the insurance company to liability for advice given by an independent insurance agent who offers competing products and over whom the insurance company cannot fully manage the advice that is offered. Thus, the Final Rule, if not modified, could impose potentially unlimited liability on insurance companies for the actions of independent insurance agents should an insurance company sign a BICE contract.

B. No Basis for Adverse Treatment of FIAs

The Final Rule's basis for singling out FIAs for adverse treatment is without merit. As explained at length in the IALC's legal briefs, the Department failed to explain why the robust consumer protections that already apply to FIA sales under state law are insufficient to address the risks posed by conflicts of interest. And it failed to cite any evidence supporting its assertion that FIA sales are inflicting losses on consumers. Instead, it based that assertion on studies of mutual funds that cannot be extrapolated to FIAs, on an academic study that does not even discuss FIAs, and on outdated and irrelevant studies of other products in other countries that are not subject to the suitability rules that apply to FIA sales in the U.S. As explained by a recent academic article on which the Department itself repeatedly relied, suitability rules "can help to meaningfully mitigate the risk of incompetent or self-interested advice."[10]

The Department continues to express its concerns that the products may at times be improperly marketed. It continues to support its position by citing staff concerns from the

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[8] *Yearbook* at 11

[9] The Department has proposed a new PTE for Insurance Intermediaries published on January 19, 2017 in the Federal Register but has failed to finalize that PTE.

[10] D. Schwarcz & P. Siegelman, "Insurance Agents in the 21st Century: The Problem of Biased Advice," in *Research Handbook on the Economics of Insurance Law* (Edward Elgar Pub. 2015) at 60.

Securities and Exchange Commission (SEC), Financial Industry Regulatory Authority (FINRA), and the North American Securities Administrators Association (NASAA).[11] These concerns are outdated, and in many instances, inaccurate, given the meaningful insurance regulatory actions taken since they were raised, and are from staff and organizations that have no experience regulating annuity products that are not securities. For example, they are largely based on criticism of sales practices that predate the adoption and implementation of new NAIC model regulations intended to address these very criticisms. In enacting the Harkin Amendment, Congress determined that compliance with the NAIC Model Regulation is sufficient to address these concerns, and the Department has never explained why that recent congressional determination does not apply equally here. It makes no sense to cite concerns raised by securities regulators while ignoring Congress's resolution of those very concerns.

The preamble to the Final Rule repeatedly references the SEC's statement that a policyholder could lose money in an FIA. This is simply not true. Loss of principal due to market conditions does not happen with an FIA. A policyholder could be charged a surrender charge if the policyholder terminates the policy early but this is a fee charged for taking certain actions under the policy and is not a loss of principal due to changes in the market. Similarly, surrender charges are also traditionally assessed on premature termination of other fixed annuity products[12], which remain subject to PTE 84-24 – a PTE that previously treated all fixed annuity products the same. And as described above, most FIA policies include specific hardship exceptions to avoid surrender charges.

Also these criticisms are not reflected in consumer complaint data. Complaints about FIAs are extremely low – in fact well below the levels of complaints on products the SEC, FINRA, and the NASAA themselves regulate.[13] Thus, the concern that FIAs may be improperly marketed is without any basis in fact and is contrary to the most recent available data.

Some critics argue FIAs are more complex products than other fixed annuities given the array of crediting options. While it is true that companies each offer various and differing crediting options, and as described above consumers can annually change their indexing choices or select a fixed rate for the year, each option is part of a contract a state insurance department approves. In addition, it is the role of the insurance agent to provide advice to help retirement savers choose the policies and options that fit their needs. A fixed rate product may be simpler, but it may also not be the product that serves retirement savers' overall interest given the higher earnings credited by FIAs in almost all cases as described below. An interest bearing FDIC insured savings account may be a simple option for a retirement saver, but it is likely not the option that serves his or her long-term financial interests.

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[11] 81 Fed. Reg. at 21153

[12] *Yearbook at 49*

[13] *Index Compendium* Volume 21, Number 4 April 2017; NAIC Consumer Information Source at https://eapps.naic.org/cis/; SEC, *Investor Complaints and Questions*, October 10, 2016; www.finra.org/newsroom/statistics

Finally, it is worth noting that all of the foregoing flaws affect the Department's assessment of the relative benefits of the Final Rule versus its costs. As a consequence, the Department's cost/benefit assessment is itself flawed, and does not provide an appropriate basis for suggesting that the applicability date of the Final Rule should not be extended beyond the limited period of delay that the Department recently authorized.

III. FAILURE TO FINALIZE AN APPROPRIATE PTE

The Department has acknowledged the Final Rule fails to offer a workable PTE for the sale of FIAs by independent insurance agents by subsequently proposing a new PTE for Insurance Intermediaries published on January 19, 2017 in the Federal Register (the "Insurance Intermediaries PTE"). This proposed PTE recognizes the importance of preserving access by retirement savers to FIAs. As the Department stated in the preamble to its proposed PTE, "(f)ixed indexed annuities, with their blend of limited financial market exposures and minimum guaranteed values, can play an important and beneficial role in retirement preparation…"[14] Yet without corrective action by the Department retirement savers may be unable to receive advice from independent agents to include FIAs as part of their retirement planning when such advice is in their best interest.

Currently, the Department has not taken any further actions on its proposed Insurance Intermediaries PTE. Many public comments were filed with the Department indicating significant problems with the proposal. Given the time IMOs will need to comply with any terms and conditions required by a new PTE covering FIAs there will not be a workable PTE available to cover sales of FIAs to retirement savers seeking investment advice from independent insurance agents without further delay of the Final Rule.

IV. EFFECTS ON RETIREMENT INVESTORS' ACCESS TO INVESTMENT ADVICE AND PRODUCTS

As described above, the Final Rule has the practical effect of preventing retirement savers from receiving advice to purchase an FIA with IRA or pension assets from an independent insurance agent. As is generally the case with other fixed annuity products, FIAs tend to be used by Middle America to provide the security offered by a fixed income product and the protections against longevity risk offered by lifetime income guarantees. For example, the typical FIA policyholder is less than 63 years old and is concerned social security income alone will be insufficient to meet their retirement needs. The average FIA policy in 2015, the year for which the most recent data is available, was $112,000[15]. These are retirement savers who typically do not have sufficient retirement savings to justify paying annual fees to manage an active investment portfolio or to assume the market volatility risks associated with more active investment strategies. The majority (62%) of FIA sales are to

[14] 82 Fed. Reg. at 7344

[15] Secure Retirement Institute, "Indexed Annuity Buyers Metrics: A look at who is buying and why individuals are turning to indexed annuities"

IRAs.[16] The growth in this market is attributed to retirement savers who are "driven by guaranteed lifetime withdrawal benefits and funding from qualified assets…"[17].

According to the Secure Retirement Institute[18] 43% of surveyed individuals indicated guaranteed income was their primary retirement priority, and almost all of them have less than $1 million in investable assets. Another 23% of individuals prioritize preservation of principal and 80% of them have less than $1 million in investable assets[19]. These are the very individuals who purchase fixed annuities.

In the event that these retirement savers continue to purchase fixed annuities, it will be more difficult for them to purchase an FIA and some may be left without the option of an FIA. Unfortunately, these retirement investors will likely see lower earnings credited to their policies than they would receive if an FIA option remained available to them. Attached (Exhibits C and D) are illustrations of the potential lost earnings these investors will experience. Exhibit C uses the NAIC Illustration Model logic[20] to show the different rates of return an investor would experience using a currently offered 2% fixed rate and four currently offered crediting options:

1) The S&P monthly average participating rate;
2) The S&P monthly average capped rate;
3) The S&P annual point-to- point participating rate; and
4) The S&P annual point-to-point capped rate.

Exhibit D uses American Academy of Actuaries Stochastic files[21] – the same scenarios actuaries use for determining GAAP reserve and regulatory cash flow testing. In essence, the first Exhibit uses historical data and the second Exhibit uses a forward-looking projection. It is clear from this chart that over a 10- or 20-year period the account values for any of the four FIA S&P crediting options exceed the amounts a fixed rate product would produce regardless of which analysis is used.

After 10 years a $100,000 policy would result in a policy value of $121,899 under a fixed rate scenario. The ***most conservative result*** after the same 10-year period with any of the crediting methods would be $129,120 (using historic modeling) or $126,957 (using forward projections). ***On the high end***, the $121,899 would compare with $158,787 (using historic modeling) or $146,284 (using forward projections).

After 20 years the results are even starker. The $100,000 would result in policy value of $148,595 under a fixed rate scenario. The ***most conservative result*** after the same 20-year period with any of the crediting methods would be $166,719 (using historic modeling)

16 *Yearbook* at p. 41
17 *Yearbook* at p. 43
18 *Indexed Annuity Buyers Metrics* at p. 3
19 *Indexed Annuity Buyers Metrics* at p. 3
20 Section 6 - National Association of Insurance Commissioners Annuity Disclosure Model Regulation (#245)
21 American Academy of Actuaries and Society of Actuaries, Economic Scenario Generators

or $161,872 (using forward projections). ***On the high end***, the $148,595 would compare with $213,990 (using historic modeling) or $253,156 (using forward projections).

Conservatively assuming about half ($150 billion) of the outstanding FIA policies are purchased with funds from IRAs sold by independent insurance agents, the Final Rule may cost these retirement savers over the next ten years at least $7.58 billion and as much as $10.8 billion in lost earnings credited to their policies. And on the high end, assuming the same $150 billion of policies over the next twenty years, the Final Rule may cost retirement savers at least $36.5 billion and as much as $55.3 billion in lost earnings credited to their policies.

These lost earnings are significant and were not included in the Final Rule's Regulatory Impact Analysis (RIA). These costs represent real tangible harm to retirement savers unless the Final Rule is further delayed, repealed, or modified.

V. LEGAL AND ECONOMIC ANALYSIS

As described above, after the Final Rule became effective, the Department acknowledged the lack of an effective PTE for FIAs by proposing the Insurance Intermediaries PTE. The preamble to the proposed PTE expresses the Department's lack of sufficient information regarding the structure of FIAs. For example, questions exist regarding basic product design such as caps, spreads, and participation rates. It is clear from the Department's proposed exemption that it needs more time to understand how to structure an appropriate PTE for IMOs offering FIAs and other products. Until the Department has adopted a final PTE covering IMOs it is inappropriate to remove FIAs from PTE 84-24 or to allow the Final Rule to become effective. To do so would impose the costs on retirement savers described above. Such costs are unwarranted and unnecessary to protect retirement savers given the robust consumer protections under state law, including extensive disclosure requirements, suitability standards, and sales practice protections.

We also note the impact of failing to adopt an effective PTE for FIAs will also harm thousands of independent insurance agents. Today there are more than 80,000 independent insurance agents licensed to offer FIAs. And there are at least 115 IMOs through which FIAs are marketed. These agents and IMOs are all small businesses. In many rural areas of the country they are one of the few if not the only source of retirement advice for retirement savers. The Final Rule, without a workable PTE for IMOs, will likely result in the inability of these small businesses to offer FIAs to retirement savers using qualified assets such as IRAs when such products are in their customers best interest. The financial impact on these small businesses has not been included in the Final Rule's RIA.

VI. CONCLUSION

Given the significant financial harm the Final Rule will have on retirement savers as described above, we urge the Department to reconsider its inclusion of FIAs in the Final

Rule, or at a minimum to retain FIAs as eligible annuities under PTE 84-24. Alternatively, we urge the Department to further delay the effective date of the amendment making sales of FIAs ineligible to rely on PTE 84-24 until such time as it finalizes a workable Insurance Intermediaries PTE.

There is ample legal justification for delaying the Final Rule until the Department has taken appropriate action. For example, the Final Rule failed to take into consideration significant costs that will be imposed on retirement savers and the distribution channels for FIAs. In part this failure can be attributed to the change in approach from the proposed rule that maintained FIA eligibility under PTE 84-24, and the Final Rule that (without meaningful notice) exempted FIAs from that PTE. We have identified and quantified some of these costs above. They are real, significant, and harmful to retirement savers. The need to avoid these significant cost burdens alone and to protect the best interest of retirement savers justifies a further delay of the Final Rule until the Department has sufficient time to address the issues raised above.

Lastly, we urge the Department to continue working with the NAIC to achieve the Final Rule's objectives in the most efficient and effective way and to recognize the important role that state insurance departments play in regulating FIAs, insurance agents, and sales practices.

Sincerely,

Jim Poolman

Jim Poolman, Executive Director