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Suitability Obligations Applicable to Securities and Annuities

Christine Lazaro¹

Benjamin P. Edwards²

Brokers are subject to different regulatory obligations depending on the type of product being recommended to a customer. Generally, brokers are subjected to overlapping oversight and are regulated at both the federal and state level. This oversight becomes even further complicated when a broker sells a product that spans multiple regulatory schemes such as certain annuities, which may be both insurance and securities products.

This article describes a broker's suitability obligations under the new suitability rule when making recommendations which are covered by that rule. Next, it describes the additional obligations that a broker has when making a recommendation of a variable annuity. Last, it describes the obligations a broker has when recommending an equity-indexed annuity, which has sometimes been viewed as both a security and insurance and sometimes solely as an insurance product.

I. Broker's Obligations When Making Recommendations

When doing business with retail customers, brokers and brokerage firms are governed by the Securities Exchange Act of 1934 (the "Exchange Act") and the rules promulgated thereunder as well as by state statutes and regulations. In addition, brokers and brokerage firms are regulated by the Financial Industry Regulatory Authority ("FINRA"), a self-regulatory organization and are subject to the rules issued by FINRA.

A. The Suitability Rule

Brokers and brokerage firms must adhere to a suitability standard which is premised primarily on FINRA Rule 2111, and requires that a Broker have a reasonable basis for believing that a recommendation of a security or an investment strategy is

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“suitable” for a customer. Rule 2111 replaced NASD Rule 2130, and went into effect on July 9, 2012.

Rule 2111(a) provides that:

A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.³

The Supplementary Materials to Rule 2111 set forth the general principles of the rule, which state:

Implicit in all member and associated person relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of FINRA rules, with particular emphasis on the requirement to deal fairly with the public. The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct.⁴

There are three components to the suitability obligation set forth in Rule 2111, the reasonable-basis obligation; the customer-specific obligation; and quantitative suitability.

³FINRA Rule 2111(a), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859. (A “member” is a brokerage firm and an “associated person” is a Broker).

⁴ FINRA Rule 2111.01.

Reasonable-basis suitability requires the broker to reasonably believe that the recommendation is suitable for at least some customers.⁵ Customer-specific suitability requires the broker to reasonably believe the recommendation is suitable for the particular customer.⁶ Lastly, quantitative suitability requires the broker, who has discretion or de facto control over the customer's account, to reasonably believe that a series of recommended transactions are not excessive and unsuitable for a customer when taken together.⁷

In drafting Rule 2111, FINRA for the first time explicitly included investment strategies within the ambit of the rule, and mandated that the term be read broadly to include explicit recommendations to hold securities.⁸

B. Regulatory Notices on Suitability

FINRA issued a series of regulatory notices to provide guidance to its members following the adoption of Rule 2111. The regulatory notices presented a series of questions and answers, expanding the information provided through supplementary materials to the rule.

In Regulatory Notice 11-25, FINRA answered the question, “What is the scope of the term ‘strategy’ as used in FINRA Rule 2111?”⁹ FINRA responded that “the rule would cover a recommendation to purchase securities using margin or liquefied home equity or to engage in day trading, irrespective of whether the recommendation results in a transaction or references particular securities.”¹⁰

FINRA also provided an example of the type of circumstance that would create an explicit recommendation to hold a security. “The rule would apply, for example, when an associated person meets with a customer during a quarterly or annual investment review

⁵ See FINRA Rule 2111.05(a).

⁶ See FINRA Rule 2111.05(b).

⁷ See FINRA Rule 2111.05(c).

⁸ See FINRA Rule 2111.03.

⁹ See Regulatory Notice 11-25, “Know Your Customer and Suitability: New Implementation Date for and Additional Guidance on the Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations,” Q7 & A7, p. 6, May 2011, available at http://finra.complinet.com/net_file_store/new_rulebooks/fi/finra_11-25.pdf.

¹⁰ *Id.*

and explicitly advises the customer not to sell any securities in or make any changes to the account or portfolio.”¹¹ However, FINRA made clear that the suitability obligation is not implicated by a broker remaining silent; and the rule does not create an ongoing duty to monitor the account.¹²

FINRA issued a follow-up notice in May 2012, prior to the effective date of Rule 2111. In Regulatory Notice 12-25, FINRA answered the question, “What does it mean to act in a customer’s best interests?”:

In interpreting FINRA’s suitability rule, numerous cases explicitly state that “a broker’s recommendations must be consistent with his customers’ best interests.” The suitability requirement that a broker make only those recommendations that are consistent with the customer’s best interests prohibits a broker from placing his or her interests ahead of the customer’s interests. Examples of instances where FINRA and the SEC have found brokers in violation of the suitability rule by placing their interests ahead of customers’ interests include the following:

- ▶ A broker whose motivation for recommending one product over another was to receive larger commissions.
- ▶ A broker whose mutual fund recommendations were “designed ‘to maximize his commissions rather than to establish an appropriate portfolio’ for his customers.”
- ▶ A broker who recommended “that his customers purchase promissory notes to give him money to use in his business.”
- ▶ A broker who sought to increase his commissions by recommending that customers use margin so that they could purchase larger numbers of securities.
- ▶ A broker who recommended new issues being pushed by his firm so that he could keep his job.

¹¹ *Id.*

¹² *Id.*; see also Q8 & A8.

- ▶ A broker who recommended speculative securities that paid high commissions because he felt pressured by his firm to sell the securities.

The requirement that a broker's recommendation must be consistent with the customer's best interests does not obligate a broker to recommend the "least expensive" security or investment strategy (however "least expensive" may be quantified), as long as the recommendation is suitable and the broker is not placing his or her interests ahead of the customer's interests.

Some of the cases in which FINRA and the SEC have found that brokers placed their interests ahead of their customers' interests involved cost-related issues. However, the cost associated with a recommendation is ordinarily only one of many important factors to consider when determining whether the subject security or investment strategy involving a security or securities is suitable. For example, the customer's investment profile is critical to the assessment, as are a host of product or strategy-related factors such as the product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions. These are all important considerations in analyzing the suitability of a particular recommendation, which is why the suitability rule and the concept that a broker's recommendation must be consistent with the customer's best interests are inextricably intertwined.¹³

¹³ FINRA Regulatory Notice 12-25, "Suitability: Additional Guidance on FINRA's New Suitability Rule," Q1 & A1, pp. 3-4, May 2012 (internal citations and footnotes omitted), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p126431.pdf>. The following cases were cited by FINRA: *Raghavan Sathianathan*, Exchange Act Rel. No. 54722, 2006 SEC LEXIS 2572, at *21 (Nov. 8, 2006); *Scott Epstein*, Exchange Act Rel. No. 59328, 2009 SEC LEXIS 217, at *40 n.24 (Jan. 30, 2009) ("In interpreting the suitability rule, we have stated that a [broker's] 'recommendations must be consistent with his customer's best interests.'"); *Dane S. Faber*, 57 S.E.C. 297, 310, 2004 SEC LEXIS 277, at *23-24 (2004) (stating that a "broker's recommendations must be consistent with his customer's best interests" and are "not suitable merely because the customer acquiesces in [them]"); *Wendell D. Belden*, 56 S.E.C. 496, 503, 2003 SEC LEXIS 1154, at *11 (2003) ("As we have frequently pointed out, a broker's recommendations must be consistent with

In terms of defining “recommendation” under the new rule, FINRA stated that its and the SEC’s prior guidance and interpretations remain generally applicable.¹⁴

FINRA answered who a customer is for purposes of the suitability rule stating, “a ‘customer’ clearly would include an individual or entity with whom a broker-dealer has even an *informal* business relationship related to brokerage services, as long as that individual or entity is not a broker or dealer.”¹⁵ FINRA made clear that the suitability obligation applied to potential investors.¹⁶

FINRA also explained the scope of the reasonable-basis suitability obligation. It is not sufficient that the investment be suitable for some investors:

The reasonable-basis obligation is critically important because, in recent years, securities and investment strategies that brokers recommend to customers, including retail investors, have become increasingly complex and, in some cases, risky. Brokers cannot fulfill their suitability responsibilities to customers (including both their reasonable-basis and customer-specific obligations) when they fail to understand the securities and investment strategies they recommend.¹⁷

his customer’s best interests.”); *Daniel R. Howard*, 55 S.E.C. 1096, 1100, 2002 SEC LEXIS 1909, at *5-6 (2002) (same), aff’d, 77 F. App’x 2 (1st Cir. 2003); *Powell & McGowan, Inc.*, 41 S.E.C. 933, 935, 1964 SEC LEXIS 497, at *3-4 (1964) (same); *Dep’t of Enforcement v. Evans*, No. 20006005977901, 2011 FINRA Discip. LEXIS 36, at *22 (NAC Oct. 3, 2011) (same); *Dep’t of Enforcement v. Cody*, No. 2005003188901, 2010 FINRA Discip. LEXIS 8, at *19 (NAC May 10, 2010) (same), aff’d, Exchange Act Rel. No. 64565, 2011 SEC LEXIS 1862 (May 27, 2011); *Dep’t of Enforcement v. Bendetsen*, No. C01020025, 2004 NASD Discip. LEXIS 13, at *12 (NAC Aug. 9, 2004) (“[A] broker’s recommendations must serve his client’s best interests, and the test for whether a broker’s recommendations are suitable is not whether the client acquiesced in them, but whether the broker’s recommendations were consistent with the client’s financial situation and needs.”); *Robin B. McNabb*, 54 S.E.C. 917, 928, 2000 SEC LEXIS 2120, at *24 (2000), aff’d, 298 F.3d 1126 (9th Cir. 1990); *Stephen T. Rangen*, 52 S.E.C. 1304, 1311, 1997 SEC LEXIS 762, at *19 (1997); *Curtis I. Wilson*, 49 S.E.C. 1020, 1022, 1989 SEC LEXIS 25, at *6-7 (1989), aff’d, 902 F.2d 1580 (9th Cir. 1990).

¹⁴ *Id.* at Q2 & A2 and Q3 & A3, pp. 4-5.

¹⁵ *Id.* at Q6 & A6, p. 6 (emphasis in the original).

¹⁶ *Id.*

¹⁷ *Id.* at Q22 & A22, p. 14.

With respect to quantitative suitability, FINRA provided guidance that the standards that established excessive trading under the predecessor rule continue to provide a basis for establishing that recommendations may be quantitatively unsuitable under the new rule – turnover rate, cost-to-equity ratio, and in-and-out trading of an account.¹⁸

In December 2012, FINRA issued Regulatory Notice 12-55 to clarify the scope of the terms “customer” and “investment strategy” as discussed in Regulatory Notice 12-25.¹⁹

In this notice, FINRA issued revised answers to the question, who is a customer? Now, FINRA defined a customer to include “a person who is not a broker or dealer who opens a brokerage account at a broker-dealer or purchases a security for which the broker-dealer receives or will receive, directly or indirectly, compensation even though the security is held at an issuer, the issuer’s affiliate or a custodial agent (e.g., “direct application” business, “investment program” securities, or private placements), or using another similar arrangement.”²⁰

With respect to potential investors, the suitability obligation would only apply if the person becomes a customer. “Where, for example, a registered representative makes a recommendation to purchase a security to a *potential investor*, the suitability rule would apply to the recommendation if that individual executes the transaction through the broker-dealer with which the registered representative is associated or the broker-dealer receives or will receive, directly or indirectly, compensation as a result of the recommended transaction.”²¹

FINRA also clarified that the suitability rule applies only to securities transactions and not to recommendations related to non-

¹⁸ *Id.* at Q23 & A23, p. 14.

¹⁹ See FINRA Regulatory Notice 12-55, “Suitability: Additional Guidance on FINRA’s New Suitability Rule,” December 2012, available at http://finra.complinet.com/net_file_store/new_rulebooks/f/i/FINRANotice12_55.pdf.

²⁰ *Id.* at Q6(a) & A6(a), p. 2.

²¹ *Id.* at Q6(b) & A6(b), p. 2 (emphasis in the original).

securities transactions such as might arise in outside business activities.²²

II. Broker's Obligations When Recommending Annuities

Annuities pose a unique issue with respect to suitability obligations. Certain annuities, e.g. fixed annuities, are not securities and hence, the FINRA suitability obligation does not apply to the recommendation to purchase a fixed annuity. Other annuities, e.g. variable annuities, are securities and the FINRA suitability obligations clearly apply. However, there are a third category of annuities, equity-indexed annuities, which may or may not be securities.

A. Suitability and Variable Annuities

In addition to Rule 2111, FINRA Rule 2330 also applies to sales of variable annuities.²³

Rule 2330 outlines a broker's responsibilities regarding deferred variable annuities. In addition to complying with the suitability obligations set forth in Rule 2111, the broker has further obligations. Specifically, the broker must have a reasonable basis to believe that "the customer has been informed, in general terms, of various features of deferred variable annuities, such as the potential surrender period and surrender charge; potential tax penalty if customers sell or redeem deferred variable annuities before reaching the age of 59½; mortality and expense fees; investment advisory fees; potential charges for and features of riders; the insurance and investment components of deferred variable annuities; and market risk."²⁴

²² *Id.* at Q10(a) & A10(a), p. 4.

²³ "Deferred variable annuities have many unique features that make them complex investments. In addition to the hybrid nature of deferred variable annuities (i.e., they contain both securities and insurance features), most deferred variable annuities offer numerous choices among a number of complex contract features.⁶ Moreover, the amount that will accumulate and be paid to the investor pursuant to a deferred variable annuity will fluctuate depending on the investment options that the investor chooses." *See* NASD Notice to Members 04-45, "Proposed Rule Governing the Purchase, Sale, or Exchange of Deferred Variable Annuities," June 2004, available at <http://www.finra.org/sites/default/files/NoticeDocument/p003009.pdf>.

²⁴ FINRA Rule 2330(b)(1)(A)(i).

In addition to ensuring that the customer has received material information about the variable annuity, the broker must have a reasonable basis to believe “the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit.”²⁵ The broker also has to believe the annuity as a whole, including the underlying subaccounts to which money has been allocated, as well as riders and product enhancements, are suitable for the customer.²⁶

The rule also requires that a broker make a suitability determination with respect to annuity exchanges, and requires the broker to consider whether “the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living, or other contractual benefits), or be subject to increased fees or charges (such as mortality and expense fees, investment advisory fees, or charges for riders and similar product enhancements).”²⁷ Again, the broker should consider whether the customer would benefit from product enhancements and improvements.²⁸ The broker must also consider whether any other deferred variable annuities had been exchanged in the preceding 36 months.²⁹

Like Rule 2111, Rule 2330 also sets forth the type of information a broker should obtain from a customer prior to making a recommendation: “information concerning the customer's age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, investment time horizon, existing assets (including investment and life insurance holdings), liquidity needs, liquid net worth, risk tolerance, tax status, and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers.”³⁰

²⁵ FINRA Rule 2330(b)(1)(A)(ii).

²⁶ See FINRA Rule 2330(b)(1)(A)(iii).

²⁷ FINRA Rule 2330(b)(1)(B)(i).

²⁸ See FINRA Rule 2330(b)(1)(B)(ii).

²⁹ See FINRA Rule 2330(b)(1)(B)(iii).

³⁰ FINRA Rule 2330(b)(2).

Although this rule applies to deferred variable annuities, it does not apply to fixed annuities or equity-indexed annuities.

B. Defining Equity-Indexed Annuities

Insurance companies quietly introduced a new breed of annuity, the equity-indexed annuity, in the mid-1990s.³¹ These products credit contract owners with returns based on the performance of some index, such as the S&P 500 or the Dow Jones Industrial Average. Because the products were most often tied to equity market indexes, they were first known as equity-indexed annuities. The products share characteristics with both fixed and variable annuities.³² Like a fixed annuity, equity-indexed annuities may offer a minimum guaranteed interest rate and, under state insurance law, the insurance company will generally guarantee a certain portion of the premium paid.³³ Like a variable annuity, the rate of return for an equity-indexed annuity will vary based on the performance of a securities index, such as the S&P 500.³⁴

Unlike variable annuities, however, equity-indexed annuities typically do not diminish in value if a market index declines in value over a set period.³⁵ If the relevant index goes down during the relevant time period, no deduction is taken from the value of the annuity.³⁶ In exchange for this downside protection, some equity-indexed annuities cap the amount that may be earned when the index's value goes up.³⁷ For example, if an index increased 6% in a year, the equity-indexed annuity might only permit a maximum rate of return of 5%. Forecasting anticipated returns

³¹ See "Indexed Annuities and Certain Other Insurance Contracts", Securities Act Release Nos. 33-8996, 34-59221, 74 Fed. Reg. 3138-01, p. 8, Jan. 8, 2009. The product has also been known as a fixed indexed annuity. For ease of reference, this Article refers to the product as an "equity-indexed annuity."

³² See FINRA, "Equity-Indexed Annuities: A Complex Choice", last updated 2010, available at http://www.finra.org/investors/alerts/equity-indexed-annuities_a-complex-choice, see also SEC, "Investor Bulletin: Indexed Annuities", April 2011, available at <http://www.sec.gov/investor/alerts/secindexedannuities.pdf>.

³³ See FINRA, "Equity-Indexed Annuities: A Complex Choice."

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

may be difficult because the insurance companies selling equity-indexed annuities may reserve the right to alter the formulas by which the investor's gains will be calculated.³⁸

Insurance companies for the most part have quietly sold equity-indexed annuities since their introduction in the mid-1990s without registering them as securities.³⁹

C. Regulating Equity-Indexed Annuities

The Securities Exchange Act of 1934 (the "Securities Act") expressly exempts annuities from coverage of the Act, stating that the provisions of the Act do not apply to "[a]ny . . . annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia."⁴⁰ Notwithstanding this explicit language, the Supreme Court first considered what Congress intended when it included the term "annuity contract" in the Securities Act in 1959 in *SEC v. VALIC*.⁴¹ In *VALIC*, the Court considered whether a variable annuity was exempt from the Securities Act, and held that it was not exempt.

At the time *VALIC* was decided, variable annuities were new products. Because the first variable annuity contracts appeared in 1952,⁴² they did not exist when the Securities Act was adopted in 1933. The Court had to decide what Congress meant when it used the term "annuity" in the Securities Act, at a time when only fixed annuities had existed.⁴³ States treated variable annuities

³⁸ Crediting formulas typically limit the amount of interest credited by imposing a variety of terms. A "participation rate," for example, limits the investor to a certain percentage of the index's performance. Some equity-indexed annuities may also cap the amount of interest an investor may receive in any given year. *See Id.*

³⁹ *See* "Indexed Annuities and Certain Other Insurance Contracts", Securities Act Release Nos. 33-8996, 34-59221, File No. S7-14-08, p. 9, January 8, 2009, available at <http://www.sec.gov/rules/final/2009/33-8996.pdf>.

⁴⁰ 15 U.S.C. § 77c(a)(8).

⁴¹ *See SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65 (1959).

⁴² *Id.* at 69.

⁴³ *See id.* at 69.

inconsistently, with some states treating variable annuities as insurance and others not.⁴⁴ The Court examined the characteristics of the variable annuity contracts to determine whether they shared traditional insurance characteristics.⁴⁵ Historically, the annuities that had been regulated under the insurance laws had been fixed annuities, which did share the traits of traditional insurance products.⁴⁶ The Court concluded that “the concept of ‘insurance’ involves investment risk-taking on the part of the company.”⁴⁷ Nevertheless, “absent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company.”⁴⁸ Accordingly, the Court held that variable annuities were not exempted from the Securities Act.⁴⁹

Over time, the insurance companies continued to develop new annuity products. In 1967, the Supreme Court was asked to decide whether a flexible-fund annuity was subject to the Securities Act in *SEC v. United Benefit Life Ins. Co.*⁵⁰ The flexible-fund annuity was an optional annuity plan which was similar to a variable annuity.⁵¹ In this case, the Court focused less on the shifting of risk and more on “the character the instrument is given in commerce.”⁵² The Court examined how the flexible funds were being sold to consumers and found that flexible funds were competing with mutual funds and being sold to consumers under the same value proposition of growth and professional management as mutual funds.⁵³ In the view of the Court, “[i]t seems eminently fair that a purchaser of such a plan be afforded the same advantages of disclosure which inure to a mutual fund purchaser under §5 of the Securities Act.”⁵⁴ Thus, the Court held

⁴⁴ *Id.*

⁴⁵ *Id.* at 71–73.

⁴⁶ *Id.* at 69.

⁴⁷ *Id.* at 71.

⁴⁸ *Id.*

⁴⁹ *Id.* at 73.

⁵⁰ *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967).

⁵¹ *Id.* at 204.

⁵² *Id.* at 211.

⁵³ *Id.*

⁵⁴ *Id.*

that the annuities were not exempt annuity contracts under the Securities Act.⁵⁵

In the mid-1980s, the SEC promulgated Rule 151 to create a safe harbor definition of annuity contracts or optional annuity contract under §3(a)(8) of the Securities Act for new products entering the market.⁵⁶ The rule was meant to ensure guaranteed investment contracts were exempt from the definition as long as certain conditions were met. Rule 151 codified the Court's holdings in *VALIC* and *United Benefit* by specifying that the insurance company must assume the investment risk under the contract and that marketing the annuity as an investment will forfeit the Securities Act exemption.⁵⁷

In 2008, the SEC sought to regulate equity-indexed annuities by proposing Rule 151A, which would make it clear that the products fell outside the safe harbor of Rule 151 and within the SEC's jurisdiction.⁵⁸ In 2009, the SEC's rulemaking process concluded and it adopted Rule 151A, which excluded from the definition of "annuity contracts or optional annuity contracts," a contract if:

- (1) The contract specifies that amounts payable by the issuer under the contract are calculated at or after the end of one or more specified crediting periods, in whole or in part, by reference to the performance during the crediting period or periods of a security, including a group or index of securities; and
- (2) Amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract.⁵⁹

Shortly after the SEC adopted Rule 151A, American Equity Investment Life Insurance Co. challenged the rule in the United

⁵⁵ *Id.* at 212.

⁵⁶ 17 C.F.R. § 230.151.

⁵⁷ *Id.*

⁵⁸ See "Indexed Annuities and Certain Other Insurance Contracts", Securities Act Release Nos. 33-8933, 34-58022; File No. S7-14-08, June 25, 2008, available at <http://www.sec.gov/rules/proposed/2008/33-8933.pdf>.

⁵⁹ 17 CFR § 230.151A (a)(1)–(2).

States Court of Appeals for the D.C. Circuit.⁶⁰ Although the court held that the SEC had reasonably interpreted the exclusion for “annuity contracts” as not exempting equity-indexed annuities, it vacated the rule because the SEC had “failed to properly consider the effect of the rule upon efficiency, competition, and capital formation.”⁶¹

Removing doubt that equity-indexed annuities could be regulated under the Securities Act, the court found that equity-indexed annuities were more like securities than annuities that traditionally benefited from the § 3(a)(8) exemption.⁶² Retail customers who purchased equity-indexed annuities did not know their annual returns until the end of the year resulting in variability in potential return and risk.⁶³ As the court noted, “[b]y contrast, an annuity contract falling under Rule 151’s exemption avoids this variability by guaranteeing the interest rate ahead of time.”⁶⁴

Following the court’s decision, Congress weighed in on the matter when it enacted Dodd-Frank.⁶⁵ Title IX, Section 989J, also known as the Harkin Amendment, directs the SEC to treat certain annuity contracts as exempt securities under the Securities Act if certain conditions are met. This exemption covers equity-indexed annuities as long as:

(1) the value of the indexed annuity does not vary according to the performance of a separate account; . . . and

(3) the indexed annuity is issued in a state that has adopted the Model Suitability Regulation or by an insurer that adopts and implements practices on a nationwide basis for the sale of annuity contracts that meet or exceed the NAIC Model Suitability Regulation.⁶⁶

⁶⁰ *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010).

⁶¹ *Id.* at 176, 179.

⁶² *Id.* at 174.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ Dodd-Frank Act, Pub. L. No. 111-203, § 989J, 124 Stat. 1376, 1949-50 (2010).

⁶⁶ Fed. Ins. Office, “How to Modernize and Improve the System of Insurance Regulation in the United States”, p. 52, 2013.

D. The NAIC Model Suitability Regulation

In 2000, NAIC⁶⁷ drafted a white paper recommending the establishment of suitability standards for life insurance and annuities.⁶⁸ At the time, six states had broad suitability standards for annuity products.⁶⁹ These states prohibited brokers from recommending a product with reasonable grounds to believe the product was unsuitable for the customer.⁷⁰ Some states provided guidance on how to determine suitability, basing it on an inquiry into criteria such as the customer’s objectives, financial situation, and needs.⁷¹ Yet most states lacked suitability requirements.⁷² After drafting the white paper, NAIC also appointed a working group to draft a model act and regulation.⁷³

An early draft of the model regulation applied only to the sale of annuities to seniors, resulting in the “Senior Protection in Annuity Transactions Model Regulation.”⁷⁴ In 2006, NAIC expanded the scope of the model regulation to apply to all annuity transactions, and it was renamed the Suitability in Annuity Transactions Model Regulation (the “Model Regulation”).⁷⁵

⁶⁷ “The National Association of Insurance Commissioners (NAIC) is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC staff supports these efforts and represents the collective views of state regulators domestically and internationally. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.” See About the NAIC, http://www.naic.org/index_about.htm.

⁶⁸ NAIC, “Suitability of Sales of Life Insurance and Annuities”, June 2000, (“NAIC White Paper”), available at <http://www.naic.org/store/free/SOS-LI.pdf>. See also, NAIC, “Suitability in Annuity Transactions Model Regulation”, LH-275-1, April 2010, (NAIC Model Regulation), available at <http://www.naic.org/store/free/MDL-275.pdf>.

⁶⁹ See e.g., IOWA ADMIN. CODE r. 191-15.8 (2011); KAN. ADMIN. REGS. § 40-2-14(c)(5) (2014); MINN. STAT. § 60K.14 (2011); MINN. STAT. § 72A.20 (2014); WIS. ADMIN. CODE INS. § 2.16(6) (2014). NAIC White Paper, at 10–14.

⁷⁰ NAIC White Paper, at 11–14.

⁷¹ *Id.*

⁷² NAIC Model Regulation, at LH-275-1.

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

The Model Regulation resembles the FINRA suitability standard. It requires that a broker have “reasonable grounds for believing that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer as to his or her investments and other insurance products and as to his or her financial situation and needs, including the consumer’s suitability information.”⁷⁶ In addition, the broker must have a reasonable basis for believing that the consumer has received specific information about the annuity, and that particular aspects of the annuity are suitable for the consumer.⁷⁷ The Model Regulation defines “suitability information” to include the following: (1) age; (2) annual income; (3) financial situation and needs, including the financial resources used for the funding of the annuity; (4) financial experience; (5) financial objectives; (6) intended use of the annuity; (7) financial time horizon; (8) existing assets, including investment and life insurance holdings; (9) liquidity needs; (10) liquid net worth; (11) risk tolerance; and (12) tax status.⁷⁸

There is substantial variation in the adoption of the Model Regulation. Some states have adopted the duties found in the Model Regulation.⁷⁹ Several states have adopted the duties found in a prior version of the Model Regulation, which define the information that must be considered in determining the suitability

⁷⁶ NAIC Model Regulation, § 6.A.

⁷⁷ *Id.* § 6.A(1)–(4).

⁷⁸ *Id.* § 5.I

⁷⁹ ALASKA ADMIN. CODE tit. 3, § 26.775 (2011); CAL. INS. CODE § 10509.914 (West 2011); COLO. CODE REGS. § 702-4:4-1-11 (2011); CONN. AGENCIES REGS. § 38a-432a-5 (2012); D.C. MUN. REGS. tit. 26-A, § 8403 (2010); FLA. STAT. ANN. § 627.4554 (West 2013); 2012-9 Haw. Rev. Stat. Ann. Adv. Legis. Serv. 608-610 (LexisNexis); IDAHO ADMIN. CODE r. 18.01.09.015 (2013); ILL. ADMIN. CODE tit. 50, § 3120.50 (2011); IOWA ADMIN. CODE r. 191-15.75(507B) (2012); KAN. ADMIN. REGS. § 40-1-14a (2013); 806 KY. ADMIN. REGS. 12:120 (2012); MD. CODE REGS. 31.09.12.04 (2014); MICH. COMP. LAWS ANN. § 500.4155 (West 2013); MINN. STAT. ANN. § 72A.2032 (West 2013); 19-2 MISS. CODE R. § 18.06 (West 2013); NEB. REV. STAT. § 44-8106 (2012); N.J. ADMIN. CODE § 11:4-59A.3 (2013); N.Y. COMP. CODES R. & REGS. tit. 11, § 224.4 (2013); N.D. CENT. CODE § 26.1-34.2-03 (2011); OHIO ADMIN. CODE 3901-6-13 (2011); OR. ADMIN. R. 836-080-0180 (2011); 11-5 R.I. CODE R. § 12:6; S.C. CODE ANN. REGS. 69-29 (2011); S.D. CODIFIED LAWS § 58-33A-16 (2012); TEX. INS. CODE ANN. art. 1115.051 (West 2011); UTAH ADMIN. CODE r. 590-230 (2012); WASH. ADMIN. CODE § 284-23-390 (2012); W. VA. CODE R. § 114-11B-5 (2011); WIS. STAT. ANN. § 628-347 (West 2012).

of the transaction less specifically and require less disclosure about the annuity.⁸⁰ One state adopted the original version of the Model Regulation as it applied only to senior consumers,⁸¹ and other states have adopted some variation of a suitability standard.⁸² Only New Mexico has not adopted any suitability standards to govern annuity sales.⁸³

The Harkin Amendment assumed that by June 16, 2013, states would have adopted the Model Regulation. However, as outlined above, only about two-thirds of the states have done so. Presently, it is unclear whether the SEC will seek to exercise regulatory responsibility over equity-indexed annuities in those states that have not adopted the Model Regulation.

While the sale of an equity-indexed annuity would likely be subject to the Model Regulation as opposed to FINRA Rule 2111, FINRA has made it clear the other transactions in connection with the recommendation of equity-indexed annuity may be subject to FINRA Rule 2111. “Moreover, all recommendations to liquidate or surrender a registered security such as a mutual fund, variable annuity, or variable life contract must be suitable, including where such liquidations or surrender are for the purpose of funding the purchase of an unregistered [Equity Indexed Annuity].”⁸⁴

⁸⁰ ALA. ADMIN. CODE r. 482-1-137-.06 (2006); 054-00-082 ARK. CODE R. § 6 (LexisNexis 2009); ARIZ. REV. STAT. § 20-1243.03 (LexisNexis 2014); GA. COMP. R. & REGS. 120-2-94.06 (2006); 760 IND. ADMIN. CODE 1-72-4 (2009); LA. ADMIN. CODE tit. 37, § 11711 (2014); 211 MASS. CODE REGS. 96.06 (2014); 02-031-917 ME. CODE R. § 6 (2007); MONT. CODE ANN. §33-20-805 (2007); N.C. GEN. STAT. § 58-60-170 (2009); N.H. CODE ADMIN. R. ANN. Ins. 305.05 (2009); OKLA. ADMIN. CODE § 365:25-17-7 (2006); 40 PA. CONS. STAT. ANN. § 627-3 (2010); TENN. COMP. R. & REGS. 0780-01-86-.06 (2008); 14 VA. ADMIN. CODE § 5-45-40 (2007).

⁸¹ 18 DEL. ADMIN. CODE § 1214-6.0 (2014).

⁸² VT. STAT. ANN. tit. 8, §4724(16) (2007); MO. CODE REGS. ANN. tit. 20, § 700-1.146 (2007); NEV. ADMIN. CODE § 688A.455 (2006); 44-27 WYO. CODE R. § 11 (LexisNexis 1996).

⁸³ The NAIC tracks adoption of the Model Regulation, and its information indicates that New Mexico has not adopted the Model Regulation. NAIC Model Regulation, at LH-275-6.

⁸⁴ See NASD Notice to Members 05-50, “Equity-Indexed Annuities: Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities,” p. 5, August 2005, available at <http://www.finra.org/sites/default/files/NoticeDocument/p014821.pdf>.

III. Conclusion

This article contains an overview of some of the regulations that may apply when Brokers recommend that their clients purchase securities or different types of annuities. For cases involving annuities, much depends on the particular type of annuity at issue. While the general suitability rule laid out in FINRA Rule 2111 applies to transactions involving securities, additional FINRA or state-specific regulations may apply if a broker recommends a variable annuity or an equity-indexed annuity.