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BILL ANALYSIS

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Senate Bill 880 (as enrolled)
Sponsor: Senator Gerald Van Woerkom
Senate Committee: Banking and Financial Institutions
House Committee: Insurance

PUBLIC ACT 399 of 2006

Date Completed: 11-27-06

RATIONALE

Annuities are contracts sold by life insurance companies that provide fixed or variable payments to a named individual, the annuitant. These contracts, particularly variable annuities, which are tied to the value of stocks purchased by insurance companies, have become popular investment vehicles in recent years. Some people believe that the Insurance Code should include specific regulations regarding the recommendation and sale of annuity products to consumers because some insurance companies, and their appointed insurance producers, reportedly have taken advantage of the growing popularity of this market by selling products that may not be suitable for certain individuals based on their age and financial situation. The National Association of Insurance Commissioners (NAIC) developed a model law to address this issue and it was suggested that Michigan adopt legislation based on that model.

CONTENT

The bill created Chapter 41a ("Annuity Recommendation to Consumers") of the Insurance Code to do all of the following:

- Require an insurance producer or insurer to have reasonable grounds to believe that a recommendation to a consumer to purchase or exchange an annuity is suitable to the consumer based on his or her financial situation.**
- Require an insurance producer or insurer to make reasonable efforts to**

- obtain a consumer's financial information before executing a purchase or exchange of an annuity.**
- Require an insurer to establish and maintain a system to supervise recommendations, designed to achieve compliance with the bill, or assure that such a system is established and maintained.**
- Specify that compliance with National Association of Securities Dealers (NASD) rules satisfies the bill's requirements regarding the recommendation of variable annuities.**
- Specify situations to which Chapter 41a does, and does not, apply.**

Under the bill, "insurance producer" means that term as defined in Section 1201 of the Code, i.e., a person required to be licensed under Michigan law to sell, solicit, or negotiate insurance, and includes a business entity licensed as an insurance producer under Section 1205(2) of the Code.

The bill defines "recommendation" as advice provided by an insurance producer, or an insurer where no producer is involved, to an individual consumer, that results in a purchase or exchange of an annuity in accordance with the advice.

The bill defines "annuity" as a fixed annuity or variable annuity that is individually solicited, whether the product is classified as an individual or group annuity.

The bill took effect on September 29, 2006.

Recommendation to Senior Consumer

Under the bill, in recommending to a consumer the purchase of an annuity or the exchange of an annuity that results in another insurance transaction or series of insurance transactions, an insurance producer, or an insurer if no producer is involved, must have reasonable grounds to believe that the recommendation is suitable for the consumer on the basis of the facts the consumer disclosed regarding his or her investments and other insurance products and his or her financial situation and needs. Before executing a purchase or exchange of an annuity resulting from a recommendation, the insurance producer or insurer must make reasonable efforts to obtain the consumer's financial status, tax status, and investment objectives, as well as other information used or considered to be reasonable by the producer or insurer in making recommendations to the consumer.

Neither an insurance producer nor an insurer, if no producer is involved, has any obligation to a consumer related to any recommendation, if a consumer does any of the following:

- Refuses to provide relevant information requested by the insurer or insurance producer.
- Decides to enter into an insurance transaction that is not based on a recommendation of the insurer or insurance producer.
- Fails to provide complete or accurate information.

An insurer's or insurance producer's recommendation must be reasonable under all the circumstances actually known to the insurer or producer at the time of the recommendation.

Insurers' Powers & Duties

The bill requires an insurer either to assure that a system to supervise recommendations that is reasonably designed to achieve compliance with Chapter 41a is established and maintained, or to establish and maintain such a system, including maintaining written procedures and conducting periodic reviews of its records that are reasonably designed to assist in detecting and preventing violations of the chapter. An insurance producer must either adopt a system

established by an insurer to supervise recommendations of its insurance producers that is reasonably designed to achieve compliance with Chapter 41a, or establish and maintain such a system, including maintaining written procedures and conducting periodic reviews of records that are reasonably designed to assist in detecting and preventing violations of the chapter.

An insurer may contract with a third party, including an insurance producer, to establish and maintain a system of supervision of insurance producers under contract with or employed by the third party. An insurer must make reasonable inquiry to assure that the third party is performing the functions required and must take reasonable action under the circumstances to enforce the contractual obligation to perform the functions. An insurer may comply with its obligation to make reasonable inquiry by doing both of the following:

- Annually obtaining a certification from a third party senior manager that the third party is performing the required functions.
- Periodically selecting, based on reasonable selection criteria, third parties for a review to determine whether they are performing the required functions.

An insurance producer contracting with an insurer promptly must give a certification or give a clear statement that it is unable to meet the certification criteria, when requested by the insurer.

An insurer that contracts with a third party and that complies with the supervision requirements will be considered to have met its responsibilities to establish and maintain a system of supervision or ensure that a system is established and maintained.

An insurer or insurance producer is not required to do either of the following:

- Review, or provide for review of, all insurance producer-solicited transactions.
- Include in its system of supervision an insurance producer's recommendation to consumers of products other than the annuities offered by the insurer or insurance producer.

An insurer and an insurance producer must maintain or be able to make available to the Commissioner of the Office of Financial and Insurance Services (OFIS) records of the information collected from the consumer and other information used in making the recommendations that are the basis for insurance transactions, for five years after the insurance transaction is completed by the insurer. An insurer may, but is not required to, maintain documentation on behalf of an insurance producer. Records required to be maintained may be maintained in paper, photographic, microprocess, magnetic, mechanical, or electronic media or by any process that accurately reproduces the actual document.

NASD Rules

The bill specifies that an insurer that complies with the NASD rules "NASD Manual, Conduct Rules Section 2310 (CCH, 1966)", or rules at least as stringent as Section 2310 pertaining to suitability, satisfies the requirements of Chapter 41a for the recommendation of variable annuities.

Scope

Chapter 41a applies to any recommendation to purchase or exchange an annuity made to a consumer by an insurance producer, or an insurer where no producer is involved, that results in the purchase or exchange recommended.

Chapter 41a does not apply to any recommendation to purchase or exchange an annuity involving direct response solicitations, where there is no recommendation based on information collected from the consumer, or involving contracts used to fund any of the following:

- An employee pension or welfare benefit plan that is covered by the Federal Employee Retirement and Income Security Act.
- An employer-established or -maintained pension, profit-sharing, deferred compensation, or stock bonus plan regulated under Section 401(a), 401(k), 403(b), 408(k), or 408(p) of the Internal Revenue Code (IRC).
- A government or church pension or deferred compensation plan regulated under Section 414 of the IRC, or a deferred compensation plan of a state or

local government or tax-exempt organization regulated under Section 457 of the IRC.

- A nonqualified deferred compensation arrangement established or maintained by an employer or plan sponsor.
- Settlements of, or assumptions of liabilities associated with, personal injury litigation or any dispute or claim resolution process.
- Formal prepaid funeral contracts.

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ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

According to OFIS, in recent years there has been an increase in complaints regarding the sale to senior consumers of annuities that may not be suitable investments for them because of the customers' age and financial situation. Seniors are particularly vulnerable to abuse in the form of unscrupulous sales tactics because they may have saved and accumulated wealth over many years and might not fully grasp the nature of annuity products and how investment in them would relate to the seniors' own circumstances. Although the OFIS Commissioner has the authority to take action against unscrupulous insurers or producers, the burden of proof in these instances often is a barrier to effective enforcement because the purchaser must demonstrate that the producer or insurer acted improperly in selling a product that is not in the consumer's interest. Under the bill, however, the insurer or producer must determine the suitability of an annuity product for the consumer before the sale occurs. Strictly regulating the sale and recommendation of annuity products in this manner will provide a greater degree of protection for consumers, particularly elderly investors, and their assets than previously was afforded them.

Response: While the bill offers some degree of protection to consumers and authorizes the Commissioner to take enforcement actions, Chapter 41a could be improved on several grounds. Although the OFIS Commissioner may penalize insurers and producers, the new law contains no private right of action by consumers.

Providing a private civil remedy, by allowing individuals to pursue legal claims against insurers or producers who sell or attempt to sell unsuitable annuity products, would create another incentive for annuity sellers to ensure the suitability of the investment. Moreover, the Insurance Code's enforcement provisions are insufficient to deter the practice of recommending and selling inappropriate annuity products, particularly to senior consumers.

Commissions earned on the sale of annuity products apparently are quite high and the penalties for consumers' borrowing in advance of an annuity's maturity are quite steep. Chapter 41a should require disclosure of these commissions and penalties to ensure that consumers are fully informed on the parameters of a transaction.

Also, while Chapter 41a requires an insurer or producer to maintain information provided by a consumer for five years, it does not require that the annuity recommendation or supporting documentation be maintained.

Supporting Argument

According to written testimony submitted to the Senate Banking and Financial Institutions Committee by the American Council of Life Insurers (ACLI), model regulations for senior protection in annuity transactions have been the subject of much discussion and debate over a number of years. While initial versions proposed by the NAIC were strongly opposed by the insurance industry as being too broad and intrusive, in early 2003 regulators proposed a model that was limited to the sale of annuities to individuals 65 years of age and older, but covered both fixed and variable annuities. Insurers requested that the model provide safeguards for a seller's compliance with National Association of Securities Dealers rules pertaining to suitability. According to testimony before the Senate committee by representatives of ACLI, the resultant NAIC model bill has received the approval of regulators, insurance companies, insurance producers, and consumers. The ACLI officials told the committee that 13 states had adopted the model, either as legislation or regulatory structure. The aim is to have conformity in laws regulating annuity sales to seniors from state-to-state. According to OFIS, Senate

Bill 880 was based upon that NAIC model law.

Also, according to OFIS, the ACLI recently reversed its opposition to applying the model law more broadly, and agreed to support a measure to extend annuity sale consumer protections to transactions with consumers of all ages. Based on that change of position, OFIS evidently expects that the NAIC will review the existing model and work toward expanding it to protect all consumers, as the enacted version of Senate Bill 880 does.

Opposing Argument

Annuities, particularly variable annuities, are more accurately characterized as investment tools than as insurance products. As such, they should be regulated as securities, not as insurance.

Legislative Analyst: Patrick Affholter

FISCAL IMPACT

The bill will have no fiscal impact on State or local government.

Fiscal Analyst: Elizabeth Pratt
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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.