Surprise: DOL Rule Targets Indexed Annuities

By Kerry Pechter *Thu, Apr 7, 2016*

The DOL may have put a crimp in the sales of the hot-selling but controversial annuity product when, without specific warning, it raised the regulatory bar for the sale of fixed indexed annuities. (This article is free today.)

Advisors and agents who sell fixed indexed annuities (FIAs) to retirement account owners on a commission basis will have to pledge to act in the "best interest" of the purchaser under the final version of the Department of Labor's fiduciary rule and its prohibited transaction exemptions, which the DOL released yesterday.

Specifically, FIA sellers will be bound by the terms of the new **Best Interest Contract Exemption**, or BICE. The BICE requires sellers to do what's best for the client "without regard" to their or their companies financial interests. It affects transactions entered on or after April 10, 2017.

The DOL gave no direct warning that a BIC requirement for FIA sales would be included in the final rule; it wasn't in the proposal. "I am floored," said Sheryl Moore, an FIA industry data provider and consultant. But Cathy Weatherford, CEO of the Insured Retirement Institute, said she was prepared for such a possibility.

"We're not surprised that Fixed Indexed Annuities were taken out of PTE 84-24, which advisors have used for the past 30 years to make annuities available to their clients. We have been advising our members that this was a possibility, based on our discussions with the DOL and the Administration," she said in an email to *RIJ* yesterday.

Moore said she knows of several variable annuity insurers, including mutual companies that have never sold FIAs, who have taken steps recently to develop indexed annuity products on the assumption—now dashed—that FIAs would have a regulatory advantage over VAs under the final DOL rule.

Just a few days before the release of the final version of the BIC, Fitch Ratings released a report saying that the BIC could "negatively affect sales of variable annuities into qualified plans and could positively affect sales of fixed annuities and fixed indexed annuities (FIA)."

"Of course it is significant," said Steve Saxon of Groom Law Firm in Washington, D.C. in an email. "Lots of folks thought that they could rely on PTE 84-24 for relief and avoid the BIC exemption. This will require a reevaluation of the exemption strategy. It depends, at least in

part, on whether compliance with the BIC exemption works."

Indeed, the language of the BICE itself contains concessions to the industry that could make it acceptable to the annuity industry. While the exclusive "without regard" to the financial interest of the seller language still stands (page 23), an advisor or agent doesn't have to push the contract at the client at their first meeting.

Based on an initial reading of page 24, it now appears that he or she can establish rapport, and then at the point of transaction simply include among lots of other documents a blanket BIC document in which the financial institution, not the individual advisor or agent, pledges that its representatives will act in the client's best interest. Clients will still have recourse to participate in class action suits against the institution for potential violations of the BIC.

Sales of indexed annuities in 2015 were $54.7 billion, according to IRI. While gross variable annuity sales were much higher, at $130.4 billion, the VA industry suffered net outflows in the third and fourth quarters. One source in the FIA industry suggested to *RIJ* that variable annuity issuers "lobbied" the DOL to level the playing field between FIAs and VAs by applying the BIC to both—a plausibly paranoid idea. About 56% of all fixed annuity premia in 2015 was tax-deferred money.

The language of the BIC is still too fresh to say exactly how its terms, which were softened in the final version, will affect sales of either product. Shares of American Equity Life, a leading publicly-held issuer of indexed annuities, lost $2.48 yesterday, or 15.34% of their value, according to Bloomberg.

The DOL likened FIAs to variable annuities in their cost and complexity. "Given the risks and complexities of these investments, the Department has determined that indexed annuities are appropriately subject to the same protective conditions of the Best Interest Contract Exemption that apply to variable annuities," the final BICE text said.

FIAs have gotten even more complex in recent years, especially with the introduction of hard-to-value "hybrid" indices that allow issuers to offer supposedly "uncapped" gains even though the gains of FIAs are by design strictly limited. But it's not clear if this trend influenced the DOL.

In the previous version of the rule, FIA sellers appeared to be spared from the BIC. The April 2015 version of the so-called fiduciary rule had allowed fixed indexed annuities, along with fixed deferred and fixed immediate or deferred income contracts, to be sold under so-called Prohibited Transaction Exemption 84-24, and not under the BIC.

But the new version changes that. It distinguishes FIAs from other fixed annuities. In doing so, it potentially conflicts with the July 2010 US District Court of Appeals ruling that FIAs are not akin to variable annuities, not securities, and not subject to regulation under SEC proposed regulation 151A.

"Fixed rate annuity contracts do not include variable annuities or indexed annuities or similar annuities. As a result, investment advice fiduciaries will generally rely on this Best Interest Contract Exemption for compensation received for the recommendation of variable annuities, indexed annuities, similar annuities, and any other annuities that do not satisfy the definition of fixed rate annuity contracts."

In the final version of the BIC, the DOL said it considered an annuity a fixed annuity under PTE 84-24 only if it offered benefits that "*do not vary*, in part or in whole, based on the investment experience of a separate account or accounts maintained by the insurer or the investment experience of *an index or investment model*" (emphasis added).

By amending the propels to put FIAs under the BICE, the DOL has, without specific warning, introduced a potential new barrier to sales of what is, at present, the most successful annuity product. It may be one of the few parts of the final rule that became more aggressive than the most recent proposal.

"I was told repeatedly by the annuity companies that they did not believe this would happen because the DOL never gave them an opportunity to comment on this possibility," a broker-dealer executive told RIJ. Others who met with the DOL shortly before the end of the comment period noted that the DOL representatives didn't include FIAs when they referred to fixed annuities during the meeting and its absence was striking to them.

An FIA trade group felt the final rule made "no sense." "We are disappointed by the decision of the DOL to treat Fixed Indexed Annuities (FIAs) differently than every other fixed annuity product," Jim Poolman, executive director of the Indexed Annuity Leadership Council, told *RIJ* in an email. "Despite countless meetings, three comment letters, and public testimony before DOL, the final rule mischaracterizes FIAs and imposes rules that make no sense. At first blush, it appears that this rule discriminates among similar insurance products without any rational basis."

The DOL said that it put FIAs under BICE because they're so complicated and hard to understand. "Retirement Investors are acutely dependent on sound advice that is untainted by the conflicts of interest posed by Advisers' incentives to secure the annuity purchase,

which can be quite substantial.

“Both categories of annuities, variable and indexed annuities, are susceptible to abuse, and Retirement Investors would equally benefit in both cases from the protections of this exemption, including the conditions that clearly establish the enforceable standards of fiduciary conduct and fair dealing as applicable to Advisers and Financial Institutions.”

In addition, the DOL said that it wanted to create a “level playing field” for FIAs and VAs, and to avoid “a regulatory incentive to preferentially recommend indexed annuities,” as the original proposal could have created. But, arguably, the DOL has chosen to provide a disincentive to recommend VAs and FIAs, and gives an implied encouragement to the sale of fixed deferred and fixed income annuities, including single premium immediate annuities, deferred income annuities, and qualified longevity annuity contracts.

“The placement of fixed indexed annuities into the BICE could cause some product redesign,’ said Jamie Hopkins, co-director of the New York Life Center for Retirement at The American College. “The good news for annuity providers is that indexed and variable annuities did get a specific exemption from the prohibited transaction rules as long as the BIC and other requirements are met” and that “a little bit of the administrative burdens and complexities regarding the ‘best interest contract’ were removed from the proposed rule in the final rule.”

In the past, VA and FIA marketers have held that the public has voted with its pocketbook in favor of their products, which have enjoyed much higher sales than simpler annuities because they offer lifetime income guarantees with more flexibility and liquidity than conventional income annuities, which offer higher monthly payouts but are generally irrevocable and illiquid.

Critics of VAs and FIAs have argued that those products enjoy higher sales mainly because of the richer sales incentives (in the form of higher commissions and other incentives) that manufacturers, broker-dealers and insurance marketing organizations offer agents and brokers, and because clients don’t fully understand how much they must pay in fees for the benefits they receive.