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Via E-Mail

Mr. Michael L. Yanacheak
Chair, Annuity Disclosure (A) Working Group
National Association of Insurance Commissioners

Via email to: Jennifer Cook (JCook@naic.org)

Re: Comments on the 3/7/2019 Exposure Draft of the Annuity Disclosure Model Regulation (#245)

Dear Mr. Yanacheak:

On behalf of the Committee of Annuity Insurers (the "Committee"), we are writing in response to the Annuity Disclosure (A) Working Group's ("Working Group") request for comment on the exposure draft of proposed revisions ("Exposure Draft") to the Annuity Disclosure Model Regulation (#245) ("Model Regulation"). The Committee appreciates the opportunity to provide comments on the Exposure Draft to assist with this important initiative to revise the Model Regulation.

OVERVIEW OF THE COMMITTEE

The Committee's member insurance companies represent over 80% of the annuity business in the United States. Committee members offer annuities through affiliated and unaffiliated distribution channels. For over 35 years, the Committee has been involved in shaping and commenting upon many elements of the regulatory framework applicable to annuity products, including regulatory matters involving the National Association of Insurance Commissioners and individual state insurance regulatory authorities, the U.S. Department of Labor, the Financial Industry Regulatory Authority, Inc. and the U.S. Securities and Exchange Commission.

COMMITTEE COMMENTS ON THE EXPOSURE DRAFT

The Committee appreciates the efforts of the Working Group to revise the Model Regulation. The Committee believes that adopting an updated, modernized framework for illustrations of fixed index annuities is an important initiative that will provide consumers with a better understanding of the features of such annuities and how they might fit with their financial needs and objectives. An illustration accompanied with fair and balanced disclosure of the illustration methodology is one of the best methods to ensure that consumers understand the product they are purchasing. The Committee therefore supports the Working Group's efforts to improve on the illustration process for fixed index annuity products. The Committee believes, however, that it is very important that the revisions to the Model Regulation strike the proper balance. If the ability to illustrate available index options is too restrictive, then consumers could be deprived of meaningful information and forego allocating funds to index options (or contracts altogether) that could be important and valuable elements of their overall retirement savings portfolios.

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The Committee has a number of comments on the Exposure Draft that either recommend revisions to the text of the Exposure Draft or that request and identify areas for which additional clarification will be important. Set forth below are the Committee's comments on:

- The increase in the required operating history of an index from 10 to 20 years (Section 6(F)(9)(b));
- The terminology describing the carve out permitting illustrations for certain indices that include a "combination of indices" which each have been in existence for 20 years (Section 6(F)(9)(b)(i));
- The requirement that the method of combination creates a unique twenty (20) calendar year history of the index (Section 6(F)(9)(b)(ii));
- The requirement that any algorithm or method of combination be "fixed" from the creation of the index (Section 6(F)(9)(b)(iii));
- The provision allowing the insurance commissioner or consumer to inspect the "algorithm or other method" supporting the index (Section 6(F)(9)(b)(iv)); and
- The disclosure requirements for indices (Section 6(G)(4)(b)(i)-(ii)).

The Index Operating History -- Section 6(F)(9)(b) and (b)(i)

Under the Exposure Draft, for an index to be eligible for illustration (for clarity, referred to herein as a "Reference Index"), the Working Group proposes to increase the required index operating history from 10 to 20 years. However, the Exposure Draft would now allow for illustration of an index with a less than 20-year operating history so long as the index is a "combination of indices," each in existence for 20 or more years, that meet certain additional conditions. The Exposure Draft language is as follows:

> If any index utilized in determination of an account value has not been in existence for at least twenty (20) calendar years, indexed returns for that index shall not be illustrated unless all of the following criteria are met: (i) [t]he index is a combination of indices, each of which has been in existence for at least twenty (20) calendar years . . . . (Section 6(F)(9)(b).)

As indicated during conference calls of the Working Group, the proposed lengthening of the timeframe required for an index to be illustrated was in response to concerns that the use of a 10-year timeframe could fail to appropriately cover a lengthy economic cycle. To the Committee's knowledge, there has not been any academic research relied upon indicating that a 20 year, rather than a 10 year, time period is more likely to be representative of a variety of different economic cycles, but rather, 20 years is simply an arbitrary, intuitive estimate of what an appropriate timeframe might be for capturing multiple business cycles. Moreover, there has been little or no evidence that the Committee is aware of indicating that a particular issue or problem has arisen from a sales practice perspective with illustrating fixed index annuities with indices that have been in the range of 10 to 20 years old. Therefore, the Committee does not believe that any evidence has been presented indicating a need to increase the required operating history from 10 to 20 years. In addition, the Committee is concerned that requiring such a long operating history to illustrate an index in a fixed index annuity would mean indices with 10 to 20 year operating histories would not be offered, which in turn could deprive consumers of robust, valuable and competitive product options.

The Committee does recognize, however, that increasing the length of the required operating history would likely provide a more varied illustration history to the consumer. The Committee is very concerned that increasing the operating history requirements to 20 years

could create (1) operational burdens on the current illustration systems, and (2) disruption to existing products. Certain existing fixed index annuity products using indices with operating histories of more than 10 years but less than 20 years could no longer be permitted to be illustrated. This proposed change would create disruption for all insurers and would have the unintended consequence of potentially picking "winners" and "losers" among life insurers and their products based on the duration of the operating history of the current mix of indices used in an insurer's fixed index annuity products.

While the Committee would prefer that the Model Regulation retain the 10-year history requirement, Committee members believe that extending the history requirement to 15-years could be workable. This would have the benefit of extending the duration of operating history for a Reference Index to capture a greater variety of economic cycles, while being less likely to create significant disruption to the existing fixed index annuity marketplace.

A Combination of Indices -- Section 6(F)(9)(b)(i)

If the Reference Index has not been in existence for 20 or more years, Section 6(F)(9)(b)(i) of the Exposure Draft would require that the Reference Index be constructed entirely of "a combination of indices, each of which has been in existence for at least (20) calendar years." The requirement that the Reference Index be "a combination of indices" represents a significant narrowing of the Working Group's prior draft language that the Reference Index be comprised "entirely of components," each of which had been in existence for the required time period.[1] The Committee is concerned that the use of the term "indices" in the proposed requirement is unduly restrictive and would result in unintended consequences beyond the aim of the Working Group members in proposing the amendment.

Indices may be made up of other indices. However, indices may also include other components, including but not limited to futures contracts, exchange traded funds ("ETFs") and other financial instruments. Many of those financial instruments are components of existing Reference Indexes and have their own established and verifiable performance histories. Prohibiting insurers and producers from illustrating Reference Indexes that are comprised in part of non-index financial instruments would affect a significant number of the Reference Indexes currently in use and stifle future product innovation and development. Moreover, it would deprive consumers of the ability to receive meaningful information about available indices through illustrations.

If one goal of the proposed requirement is to restrict the use of Reference Indexes that are comprised of financial instruments with limited performance histories, that goal would be more than sufficiently addressed by the separate requirement that a component of the Reference Index be in existence for the required time period. If another goal of the proposed requirement is to restrict the use of Reference Indexes that are comprised of financial instruments that, in the Working Group's view, raise consumer protection concerns, it would be helpful to understand the concerns of the Working Group and which financial instruments raise those concerns. In the Committee's view, it is difficult to see how prohibiting the use of Reference Indexes that are comprised in part of non-index financial instruments with established and verifiable performance histories addresses any discernable consumer protection concern.

The need to protect consumers, while ensuring product innovation and development are not discouraged, calls for the adoption of a less rigid approach. Such an approach would permit financial instruments with established and verifiable performance histories to be included in Reference Indexes. Therefore, the Committee recommends that the Working Group (1) replace the term "indices" in the proposed requirement with the term "components," and (2) condition the inclusion of a "component" in a Reference Index upon the component itself being in existence and having a performance history for the required time period. Including a component

[1] See the Working Group's June 5, 2018 draft available here: https://www.naic.org/documents/cmte_a_adwg_exposure_245_revisions.pdf?24.

in a Reference Index that does not meet that condition would result in the Reference Index failing to meet the proposed requirement. Given the significant impact that this requirement would have on the ability to illustrate a Reference Index, and the importance of all market participants clearly understanding the requirement, the Committee supports the development of a "Drafting Note" that would provide additional clarity around the important terms of this requirement (e.g., "components," "performance history").

A Unique Twenty (20) Calendar Year History -- Section 6(F)(9)(b)(ii)

For Reference Indexes that are a combination of indices, Proposed Section 6(F)(9)(b)(ii) requires that "[t]he method of combination is such that a unique twenty (20) calendar year history of the index can be constructed." The proposed requirement that the method of combination results in a unique history of the Reference Index is new, and to the Committee's knowledge, has not been addressed or explained in any detail at any prior meeting of the Working Group or in any drafting notes to the Exposure Draft. In the Committee's view, the purpose of the proposed requirement is somewhat unclear and the proposed requirement may be redundant of the requirement that the algorithm or other method of combination be "fixed from the creation of the index" which requirement the Committee addresses below. As such, the Committee recommends that the Working Group either provide an explanation of the purpose of the proposed requirement and how it is intended to operate for consideration by commenters, or eliminate the proposed requirement.

The Algorithm or Method of Combination Must Be "Fixed" from the Creation of the Index -- Section 6(F) (9) (b) (iii)

If an algorithm or other method of combination is used to construct a Reference Index, Section 6(F)(9)(b)(iii) of the Exposure Draft would require that the algorithm or other method of combination be "fixed from the creation of the index." The Committee generally supports this proposed requirement as well as other Working Group efforts to ensure that algorithms and other methods used to construct Reference Indexes are not subject to discretionary changes that could facilitate the manipulation of Reference Index values or otherwise undermine confidence in Reference Index values. The Committee is concerned, however, that strict interpretation of the proposed requirement could prevent index sponsors from modifying algorithms or other methods of combining Reference Index components in two common situations that should not create consumer protection concerns: (1) where modification becomes necessary in response to significant market-related or other events beyond the control of the index sponsor; or (2) where the changes are de minimis and are made in compliance with the index sponsor's rulebook through the applicable management or investment committee.

Algorithms and other methods of combination used to construct Reference Indexes generally are rules-based and do not change over time. However, in certain cases, it may become necessary for the index sponsor to modify the algorithm or other method of combination to ensure the continuation or integrity of the Reference Index. For example, if a significant change occurs in the composition of an index that is a component of the Reference Index or a component index becomes unavailable, the index sponsor may have no choice but to modify the algorithm or other method of combination in response to the change. Most index sponsors have established governance structures in place that allow the index sponsor to modify the algorithm or other method of combination when a change becomes absolutely necessary in response to a significant event.

To preserve flexibility for index sponsors to modify algorithms and other methods of combination in response to significant events or to make de minimis changes, the Committee recommends that the Working Group provide an exception to the proposed requirement that would allow index sponsors to modify algorithms or other methods of combination in response to significant events or to make de minimis changes as permitted by the index sponsor's written governance structure. To assist state insurance departments in compliance reviews of

changes to algorithms or other methods of combining indices in accordance with their governance structures, index sponsors could be asked to make a written copy of their governance structures available to the Commissioner of Insurance upon request, provided that appropriate assurances are made about the security and confidentiality of the information provided.[2] The Exposure Draft could also be revised to require disclosure of any changes made to the algorithm in connection with the illustration under Section 6(G)(4)(b) to alert consumers to the possible impact of such changes.

The "Algorithm or Other Method" Supporting the Index is Available for Inspection by the Insurance Commissioner or Consumer -- Section 6(F)(9)(b)(iv)

The Exposure Draft provides that, with respect to Reference Indices:

> Any algorithm or other method that is supporting such an index and is included in the illustration shall be made available for inspection at the request of the commissioner or the consumer. (Section 6(F)(9)(b)(iv).)

The Committee has a number of concerns with this provision. First, the breadth of the information about the "algorithm or other method that is supporting" the index that is subject to "inspection" is unclear. Is it anything that the index sponsor has in its records related to the index? Is it the written governance structure that index sponsors utilize to operate an index? Is it meeting minutes related to the development or maintenance of an index, or any applicable investment committees? Is it simply the disclosure materials that index sponsors use to describe and market their indices? As a preliminary matter, the Committee believes in robust disclosure about the nature of the algorithm, its purpose and the way in which it achieves that purpose. However, from a practical standpoint boundaries should be created around the scope of the materials subject to inspection.

Second, providing detailed and technical information about the algorithm to a *consumer* is likely to confuse, rather than clarify, how the index works for most consumers. The Committee believes that clear, concise and simplified disclosure about the index would be much more useful to the consumer.

Third, insurers issuing fixed index annuities will be limited in their ability to comply with these inspection requirements to the extent that they have existing contractual agreements with index sponsors that prohibit insurers from sharing certain contractually defined confidential materials with any third party, including potentially any consumer. Even if insurers had the information, they may not be in a position to provide the information for inspection.

Fourth, index sponsors logically could view the information about their algorithms as trade secrets and/or proprietary information that they would not want to share with consumers, and even in some cases regulators, without proper safeguards that such information would not be available in the public domain.

Fifth, if the information about algorithms were publicly available, it is conceivable that market participants able to understand and recognize the hedging requirements and strategies related to the index could rely on that information to develop their own trading strategies based on their anticipation of what would be required of insurers to hedge the index. This creates the possibility that market participants could trade in a manner that not only has a negative effect on returns for consumers, but also could potentially create systemic market risk.

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[2] As indicated below, maintaining confidentiality of the algorithm is extremely important. If the algorithm becomes publicly available, technically capable parties could analyze it and develop undesirable arbitrage opportunities that could negatively affect consumers.

The Committee understands that at least one possible reason for this requirement is to ensure that there is appropriate authentication taking place with respect to the index calculation. The Committee understands that concern, and would support a more directed, and measured approach to address that issue. For example, the Working Group may want to assess whether a company could indicate authentication related to the index calculations through:

- Actuarial certifications;
- Third party verifications of performance by independent accounting firms; or
- Publishing a statement of compliance with the International Organization of Securities Commissions (IOSCO) Principles for Financial Benchmarks.

Disclosure Requirements for Indices -- Section 6(G)(4)(b)(i)-(ii)

Under the Exposure Draft, certain disclosures are required to accompany an illustration of a Reference Index which is a combination of components, including but not limited to the following:

> Either the weights used in combining the indices are constant over time, or the weights are based on an algorithm that is consistently applied over time but may produce different weights in different years. (Section 6(G)(4)(b)(i)(III) and (ii)(II).)

The Committee generally supports the concept and principles outlined in the disclosures. However, with respect to the provision above, the Committee is concerned with the ability of the insurer issuing the fixed index annuity to confirm the accuracy of this disclosure, since the index will, in most cases, be sponsored and operated through an independent index sponsor. As a result, the Committee recommends that the Model Regulation indicate that for purposes of this requirement, the insurer is entitled to rely on annual certifications confirming the accuracy of the disclosure from the index sponsor.

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The Committee appreciates the opportunity to comment on the Exposure Draft. Please do not hesitate to contact Stephen Roth (202.383.0158 or steveroth@eversheds-sutherland.com), Eric Arnold (202.383.0741 or ericarnold@eversheds-sutherland.com), Maureen Adolf, Senior Policy Adviser/Insurance (212.389.5028 or maureenadolf@eversheds-sutherland.com), or Thomas Bisset (202.383-0118 or thomasbisset@eversheds-sutherland.com) with any questions or to discuss this comment letter. We note that the Committee would be happy to provide any additional information or discuss any of the issues or concerns identified in this letter if and when that would be helpful.

Respectfully submitted,

Eversheds Sutherland (US) LLP

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FOR THE COMMITTEE OF ANNUITY INSURERS

CC: John Robinson, Minnesota (via email)
Matthew Gendron, Rhode Island (via email)