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May 9, 2022

Via E-Mail

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 22-08
FINRA Reminds Members of Their Sales Practice Obligations for Complex Products and Options and Solicits Comment on Effective Practices and Rule Enhancements

Dear Ms. Mitchell:

We are submitting this letter on behalf of the Committee of Annuity Insurers (the "Committee"),[1] in response to FINRA Regulatory Notice 22-08, *FINRA Reminds Members of Their Sales Practice Obligations for Complex Products and Options and Solicits Comment on Effective Practices and Rule Enhancements* (the "Notice"), issued by the Financial Industry Regulatory Authority, Inc. ("FINRA") on March 8, 2022.[2] The Notice solicits comment on effective practices and rule enhancements related to the sale of complex products and options.

BACKGROUND

The Notice acknowledges that the number of accounts trading in complex products and options has increased significantly in recent years – particularly through accounts on self-directed platforms. The Notice further acknowledges that there is no standard definition for the term "complex product."[3] Instead, FINRA construes the term flexibly to include "product[s] with feature[s] that may make it difficult for a retail investor to understand the essential characteristics of the product and its risks . . . ."[4] FINRA acknowledges in the Notice that "complex products

[1] The Committee is a coalition of many of the largest and most prominent issuers of annuity contracts. The Committee's 30 member companies represent approximately 80% of the annuity business in the United States. The Committee was formed in 1981 to address legislative and regulatory issues relevant to the annuity industry and to participate in the development of insurance, securities, banking, and tax policies regarding annuities. For over four decades, the Committee has played a prominent role in shaping government and regulatory policies with respect to annuities at both the federal and state levels, working with and advocating before the SEC, CFTC, FINRA, IRS, Treasury Department, and Department of Labor, as well as the NAIC and relevant Congressional committees. A list of the Committee's member companies is available on the Committee's website at www.annuity-insurers.org/about-the-committee/.

[2] See, e.g., FINRA Regulatory Notice 22-08, FINRA Reminds Members of Their Sales Practice Obligations for Complex Products and Options and Solicits Comments on Effective Practices and Rule Enhancements (March 8, 2022), available here.

[3] *Id.* at pg. 3.

[4] *Id.*

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serve a role in our financial markets" and "do not always translate into more investment risk" but do present a risk of "confus[ing] investors who may not adequately understand their features."[5]

The Notice focuses on how retail investor confusion could be heightened when a retail investor engages in a securities transaction related to a complex product through a self-directed platform and without the assistance of a financial professional to explain the key features and risks of the product.[6] The Notice seeks comment on: (1) effective practices that members have developed for complex products; and (2) whether the current regulatory framework, which was adopted at a time when the majority of individuals accessed financial products through financial professionals, rather than through self-directed platforms, is appropriately tailored to address current concerns raised by complex products.[7]

COMMITTEE COMMENTS

The Committee appreciates the opportunity to submit comments in response to this Notice. The Committee has limited its comments solely to that portion of the Notice that discusses complex products and is not providing comments on Options. For the reasons described in further detail below, to the extent FINRA undertakes future rulemaking targeting retail investor transactions in complex products, FINRA should focus on transactions in self-directed accounts – where retail investors are not afforded the advice and guidance of a licensed financial professional. To the extent FINRA undertakes a broader rulemaking effort, FINRA should keep in mind the existing, robust regulatory framework around transactions in registered insurance products – as outlined in further detail below. This framework already imposes significant customer protection obligations on broker-dealers' sale of registered insurance products. The Committee offers the following specific comments in response to this Notice.

A. Any Potential Rulemaking Concerning Complex Products Should Focus on Self-Directed Accounts

For more than a decade, FINRA has published guidance regarding the application of FINRA rules to transactions by retail investors in complex products.[8] As stated in the Notice, FINRA's interest in complex products is fueled by the inherent risk of confusion when a retail investor purchases a product with essential characteristics and features that may be difficult for the retail investor to understand.[9] The Notice acknowledges that the risk of retail investor confusion may be heightened "when retail investors make self-directed decisions through online platforms without the assistance of a financial professional."[10] In fact, one of the central underlying themes in the Notice is that the current regulatory framework, which was built on the premise that the majority of retail investors would engage a financial professional, may not be appropriately tailored to online, self-directed platforms, where retail investors have increasingly been provided access to complex products.[11]

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[5] *Id.* at pg. 4.

[6] *Id.* at pg. 4,5,10,13.

[7] *Id.* at pg. 1.

[8] *See*, e.g., FINRA Regulatory Notice 12-03, Complex Products, Heightened Supervision of Complex Products (Jan. 2012), available here.

[9] *See* the Notice at pg. 3.

[10] *Id.* at pg. 5.

[11] *Id.* at pg. 1.

The SEC echoed this same sentiment in an October 2020 Joint Statement Regarding Complex Financial Products and Retail Investors.[12] In the Joint Statement, then-SEC Chairman Jay Clayton, and then-directors of the Division of Investment Management, Corporation Finance, and Trading and Markets, noted that they were undertaking a review of the "effectiveness of the existing regulatory requirements in protecting investors – particularly those with self-directed accounts – who invested in leveraged/inverse products and other complex products."[13] The SEC's Joint Statement highlights its concern over retail investors' independent selection of complex products and noted "self-directed investors do not have the required protections that apply when they receive recommendations or advice from a broker or investment adviser."[14] The Joint Statement described those protections as, in part, advice as to the characteristics and potential risks and rewards of an investment.[15]

The risk of investor confusion in connection with transactions in complex products is mitigated by the presence of a licensed financial professional who can educate the investor about the benefits, risks, rewards, and features of a recommended product. The Committee's members are life insurance companies, most of which have affiliated broker-dealers that distribute and/or sell insurance products that are also registered securities ("registered insurance products"). In addition, the registered insurance products of most Committee members are also distributed through unaffiliated broker-dealers as a result of selling agreements with those firms. Registered insurance products are long-term investments that are typically sold through discussions between financial professionals and potential customers. Those financial professionals typically have established long-term relationships with customers and are available to address any questions raised by customers.

As described in greater detail below, the financial professional recommending a registered insurance product must be appropriately licensed under FINRA rules and state law to sell both securities and insurance products. The presence of a dually licensed financial professional in registered insurance product transactions affords the retail investor the opportunity to understand the benefits and risks of a particular registered insurance product investment. This interaction between the retail investor and a financial professional is the precise interaction that the Notice implies is lacking when a retail investor purchases a complex product through an online, self-directed platform.

To this end, the Committee believes that any FINRA rulemaking regarding complex products should take a risk-based approach that focuses on self-directed accounts and platforms – where retail investors can effect securities transactions in a wide range of products without the opportunity to receive advice from a licensed financial professional.

B. Annuity Products are Highly Regulated

If FINRA decides to undertake a broader rulemaking effort that looks beyond self-directed platforms, it should consider the comprehensive federal and state laws, and FINRA rules, that already apply to transactions in, and disclosure related to, registered insurance products. We review this framework below.

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[12] *See* Securities and Exchange Commission, Joint Statement Regarding Complex Financial Products and Retail Investors (Oct. 28, 2020), available here.

[13] *Id.*

[14] *Id.*

[15] *Id.*

1. State Insurance Regulation

State insurance regulations have targeted provisions relating the sales and marketing of annuity products. In this regard, we note the following:

- State insurance regulations address how life insurance companies can advertise their annuity products. These rules generally are intended to ensure that the format and content of any advertising materials is not misleading, deceptive, or confusing. This is measured using the standard of what impression and effect the materials would reasonably have on a person not knowledgeable in insurance matters.

- Under the NAIC Suitability in Annuity Transaction Model Regulation (Model 275), all recommendations by agents and insurers must be in the best interest of the consumer. Further, agents and carriers may not place their financial interest ahead of the consumers' interest in making a recommendation.[16] To date, nearly half of the states have updated their state approved versions of Model 275 to include a best interest standard. Model 275 also imposes express training obligations on insurers and insurance producers with respect to annuity products. These are intended to ensure that licensed insurance producers understand annuity products generally and also understand the annuity products issued by a specific insurer. The insurer's supervisory system also must include product-specific training that explains all the material features of its annuity products to its licensed insurance producers.

- Many states also have adopted the NAIC's Annuity Disclosure Model Regulation (Model 245), which requires the delivery of an appropriate "Buyer's Guide" and disclosure document to the annuity purchaser to assist with understanding the annuity product.

- State insurance laws also regulate transactions in which one annuity contract is replaced by another, such as in an exchange, direct transfer, or rollover. Many states require certain procedures be followed before the issuance of a replacement annuity contract. IRAs are subject to these requirements, although exemptions may apply for certain types of group annuities and annuities issued to qualified plans. In order to reduce the opportunity for misrepresentation or unfair practices, many states also require that a special notice be provided to a customer in a replacement transaction. The notice generally discusses important information that the customer should consider before replacing a contract. In some cases, the notice also will include a comparison of the values and costs of the contracts involved. In addition, customers who replace their annuity contracts generally are given a longer period in which to revoke their contracts after issuance.

- State insurance laws in many jurisdictions preserve and implement a purchaser's right to return or cancel an insurance contract for any reason within a specific time after delivery of the contract following purchase (typically referred to as "free look" requirements) and receive a refund of their original investment.

- Registered insurance products are also subject to review and approval by state insurance regulatory authorities, who may decline approval on consumer protection grounds.

[16] NAIC's Model 275, which was revised in 2019 to clarify that all recommendations must be in the "best interest" of the consumer, can be found here.

2. Securities Law Requirements

In addition to state insurance regulatory requirements, registered insurance products are subject to federal securities laws and regulations.

i. *SEC Regulation Best Interest ("Reg BI")*

The SEC's Reg BI establishes a "best interest" standard of conduct for broker-dealers and associated persons when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities (the "General Obligation").[17] The General Obligation is satisfied by meeting the following four component obligations: Disclosure Obligation, Care Obligation, Conflict of Interest Obligation, and Compliance Obligation. As discussed above, registered insurance products sold through a broker-dealer distribution channel are sold almost exclusively after discussions between a licensed financial professional and a retail investor. Therefore, Reg BI, including the General Obligation and each of the four component obligations detailed below, applies to most transactions involving registered insurance products when those products are sold through a broker-dealer.

- *Disclosure Obligation*: The Disclosure Obligation requires broker-dealers or natural persons who are associated persons of a broker-dealer to, prior to or at the time of the recommendation, provide the retail customer, in writing, full and fair disclosure of all material facts relating to the scope and terms of the relationship with the retail customer and all material facts related to conflicts of interest that are associated with the recommendation.[18]

- *Care Obligation*: The Care Obligation requires broker-dealers or natural persons who are associated persons of a broker-dealer to exercise reasonable diligence, care, and skill in making the recommendation.[19]

- *Conflict of Interest Obligation*: The Conflict of Interest Obligation requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to: (1) identify and at a minimum disclose, or eliminate, all conflicts of interest associated with recommendations; (2) identify and mitigate any conflicts of interest associated with recommendations that create an incentive for an associated person of a broker-dealer to place the interest of the broker-dealer, or associated person, ahead of the interest of the retail customer; (3) identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations, and prevent such material limitations and associated conflicts of interest from causing the broker-dealer, or an associated person of the broker-dealer, to make recommendations that place the interest of the broker-dealer, or such associated person, ahead of the interest of the retail customer; and (4) identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.[20]

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[17] *See* Regulation Best Interest, Securities Exchange Act Release No. 86031 (June 5, 2019), 84 Fed. Reg. 33318 (July 12, 2019) ("Reg BI Adopting Release").

[18] 17 C.F.R. § 240.15l-1(a)(2)(i).

[19] 17 C.F.R. § 240.15l-1(a)(2)(ii).

[20] 17 C.F.R. § 240.15l-1(a)(2)(iii).

- *Compliance Obligation*: The Compliance Obligation requires broker-dealers to establish, maintain, and enforce policies and procedures reasonably designed to achieve compliance with Reg BI as a whole. As a result of this requirement, a broker-dealer's Reg BI policies and procedures must address not only conflicts of interest, but also compliance with the Disclosure Obligation and Care Obligation under Reg BI.[21]

A broker-dealer and its associated persons must comply with the General Obligation and the four component obligations under Reg BI when making a recommendation to a retail customer, including a recommendation for complex products. In fact, while Reg BI's rule text does not explicitly address complex products, the Reg BI Adopting Release provides guidance as to how broker-dealers should handle recommendations of complex products in certain contexts. As stated in the Notice, Reg BI's Adopting Release "emphasized the importance of understanding the terms, features, and risks of complex products" before broker-dealers recommend them to a retail customer.[22] Further, the Adopting Release provides that "when broker-dealers are recommending complex or costly products, they should first consider whether less complex or costly products could achieve the same objectives for their retail customers."[23] These are important investor protection standards that broker-dealers must follow when making a recommendation of a complex product to a retail customer.

On the contrary, Reg BI does not apply to self-directed or otherwise unsolicited transactions by a retail customer.[24] Therefore, retail customers transacting in complex products through online, self-directed platforms are not afforded Reg BI's investor protection mechanisms in the same way they would be if they bought the same product through a financial advisor. For these reasons, and those set forth above, the Committee respectfully requests that FINRA limit any future rulemaking concerning complex products to retail investors' transactions through online, self-directed platforms.

ii. *FINRA Rule 2330*

FINRA also imposes principal review, supervision, and training requirements with respect to certain annuities that are securities. For variable annuities, many of these requirements are set forth in FINRA Rule 2330 – a rule specifically designed for and applicable only to variable annuities.[25] Under these requirements, a registered representative recommending a variable annuity purchase must have a reasonable basis to believe that (a) the customer has been informed in general terms of various features of a deferred variable annuity; (b) the customer would benefit from certain features of a deferred variable annuity, such as deferred growth, annuitization, or a death or living benefit; and (c) the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated, and riders and product enhancements, if any, are suitable for the particular customer based on required customer information.

As indicated above, if FINRA decides to undertake a broader rulemaking effort that looks beyond self-directed platforms and could impact registered insurance products, it should be mindful of the comprehensive federal and state laws, and FINRA rules, that already apply to transactions in registered insurance products.

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[21] 17 C.F.R. § 240.15l-1(a)(2)(iv).

[22] *See*, the Notice at pg. 10.

[23] *See* Reg BI Adopting Release, 84 Fed. Reg. 33318, 33381.

[24] *Id.* at 33384.

[25] *See* FINRA Rule 2330.

iii. *Securities Act of 1933 (the "1933 Act")*

The 1933 Act imposes an obligation on insurance company issuers of registered insurance products to provide contract owners with a prospectus that includes a substantial amount of information about the products and how they operate, including information about key features and risks, so that contract owners can make informed investment decisions. The prospectus must include disclosure that is "clear, concise, and understandable"[26] and written in "plain English."[27] Prospectuses are also required to be provided for the underlying mutual funds or other investment options offered under variable annuities. Registered insurance product prospectuses generally are required to disclose:

- The benefits, guarantees, risks, and costs associated with the registered insurance product;
- Maximum charges for all product fees and expenses;
- The range of total operating expenses for the underlying funds offered within the variable annuity contract;
- Numerical examples of applicable fees and charges, based on specified assumptions;
- Explanations and examples of how optional guaranteed benefits operate (*i.e.*, guaranteed withdrawal and accumulation riders, death benefits, etc.); and
- High-level information about the underlying funds available under the variable annuity contract, through a Fund Appendix, which provides basic information about each underlying fund that facilitates purchaser comparisons of funds.

Disclosure in the prospectus is also closely scrutinized and vetted by the SEC staff prior to the registration statement, which includes the prospectus, becoming effective and in connection with any updates to the prospectus. Further, registered insurance products are not simply subject to a one-time prospectus delivery requirement. Issuers of registered insurance products have an obligation to continuously update disclosures in product prospectuses and to deliver updated disclosure to contract owners.

[26] *See* Rule 421(b) under the 1933 Act. The prospectus must: (1) present information in clear, concise sections, paragraphs, and sentences using short, explanatory sentences and bullet lists; (2) use descriptive headings and subheadings; (3) avoid frequent reliance on glossaries or defined terms; and (4) avoid legal and highly technical business terminology.

[27] See Rule 421(d) under the 1933 Act. Rule 421(d) requires that plain English principles be applied to the organization, language, and design of the front and back cover pages, the summary, and the risk factors section of the prospectus. This includes adhering to the following writing principles: (1) short sentences; (2) definite, concrete, everyday words; (3) active voice; (4) tabular presentation or bullet lists for complex material; (5) no legal jargon or highly technical business terms; (6) no multiple negatives.

CONCLUSION

The Committee appreciates the opportunity to provide these comments on the Notice. Please do not hesitate to contact Clifford Kirsch (212.389.5052 or CliffordKirsch@eversheds-sutherland.com) or Eric Arnold (202.383.0741 or EricArnold@eversheds-sutherland.com) with any questions or to discuss this comment letter.

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Respectfully submitted,

EVERSHEDS SUTHERLAND (US) LLP

BY: _____
Clifford Kirsch

BY: _____
Eric Arnold

FOR THE COMMITTEE OF ANNUITY INSURERS