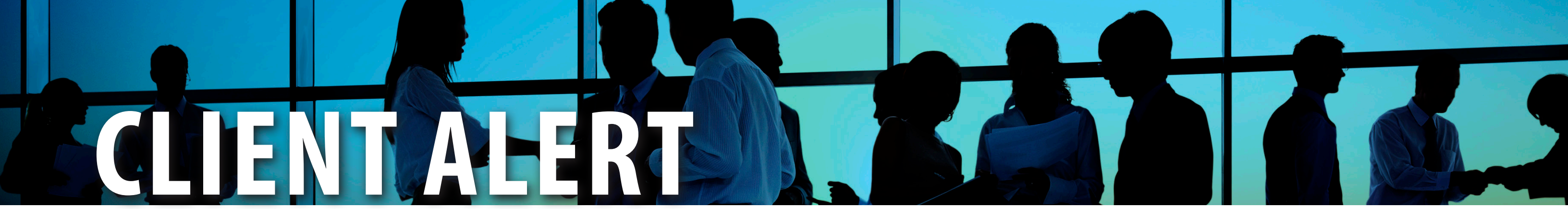





## FEE-BASED ANNUITIES: A POTENTIAL INSURANCE TRAP FOR THE UNWARY FINANCIAL PLANNER

*by Randolph F. Pistor II*

Sales of fee-based annuities have soared in recent years. However, the financial planners and investment advisers that use them with clients may be unknowingly exposing themselves to future enforcement action from state insurance regulators. As is often the case with hybrid products, the devil is in the details. First, however, a little background information is needed.

### Background

"Fee-based" or "fee-only" annuities are insurance products designed for distribution through the registered investment adviser ("RIA") channel rather than the traditional broker-dealer or insurance agency channel. Instead of receiving a sales commission, financial planners who recommend fee-based annuities are paid a flat, ongoing annual advisory fee, typically calculated as a percentage of the underlying value of the annuity contract. In other words, fee-based annuities pay no sales load to compensate the financial planner. Thus, what makes an annuity "fee-based" is its compensation structure. There are both fee-based fixed indexed annuities ("FIAs"), most of which are not securities,[1] and fee-based variable annuities ("VAs"), which are always securities.[2]

According to the LIMRA Secure Retirement Institute, fee-based FIA sales jumped 55% in the fourth quarter of 2021 to $74.5 million. More significantly, fee-based VA sales rose to $1.24 billion in the fourth quarter of 2021, an increase of 24% from 2020, marking the fifth consecutive quarter of fee-based VA product sales over $1 billion. In 2021, fee-based VA sales topped out at $4.9 billion, a 49% increase from 2020.[3] This rise in popularity is not surprising and has been driven by three main factors.

First, the financial planning industry has seen an ongoing shift to fee-only practices due to the financial stability and benefits of recurring advisory revenue.[4] This trend was accelerated beginning in 2016 with the Department of Labor's ("DOL") open disdain for broker-dealer commissions derived from sales involving individual retirement accounts ("IRAs").[5]

Second, in 2019, the Internal Revenue Service began issuing private letter rulings ("PLRs") to insurance companies which allow an advisory fee to be withdrawn directly from a fee-based annuity sold at net asset value (i.e., without a sales commission) as compensation to an investment adviser that provides ongoing investment advice to the owner of the annuity contract. Prior to the issuance of such PLRs, withdrawing advisory fees from the annuity would have triggered taxes and penalties for the annuity owner as an early distribution. Under the terms of the PLRs, investment advisers can now charge (and annuity owners will pay) an advisory fee not to exceed 1.5% as "consideration" for investment advice provided by the investment adviser in relation to the annuity contract.[6] The PLRs also indicate that the contract owner will receive ongoing investment advice from the investment adviser concerning the annuity contract, which includes helping the owner select options related to the contract, and the fees will only be used to pay for investment advisory services related to the contract.[7]

Third, many financial planners prefer (or are invited) to discard their Financial Industry Regulatory Authority ("FINRA") licenses for the comparative ease of working within the RIA model. The number of FINRA-registered representatives has been slowly declining for years,[8] while the number of state-registered investment advisers has continued to climb[9], given the ease of registration and the perceived freedom from more onerous FINRA oversight. As one large annuity manufacturer has advertised, "Our fully licensed concierge team makes it possible for independent, non-licensed wealth managers to access annuity products without the need to hold state insurance licenses or FINRA registrations."[10]

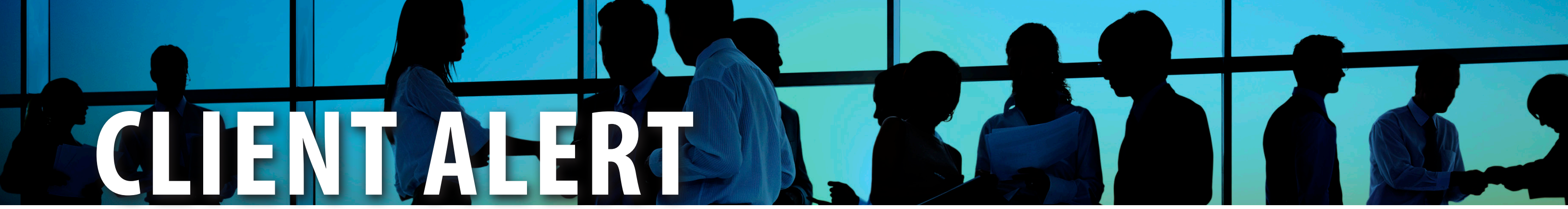
### A Trap for the Unwary

The belief that selling fee-based annuities does not require a separate insurance license is quite common; however, it is also quite mistaken in some jurisdictions. Given the expanding popularity of fee-based annuities, the failure of many financial planners to obtain additional insurance licensing could very well constitute a lurking but growing enforcement risk, especially as insurance regulators' awareness of these popular annuity products increases.

The reason for the misunderstanding is not surprising. When selling a VA that pays a sales commission, financial planners are fully aware that they must hold both a FINRA securities license (Series 6 or Series 7) and an insurance producer license due to the hybrid nature of the VA product. Because a VA straddles the securities and insurance regulatory regimes, financial planners need two licenses to satisfy both securities and insurance regulations.

So what happens when the VA no longer pays a sales commission and instead pays an ongoing advisory fee? Financial planners are correct that FINRA broker registration is no longer required. Instead, they must operate as an investment adviser representative ("IAR") of an RIA, either by obtaining a Series 65 (or Series 66) license or holding one of several professional designations.[11] The conclusion about IAR status is certainly correct for fee-based VAs, since a financial planner will receive an ongoing advisory fee as payment for advice about a security. In the case of fee-based FIAs, IAR status would be largely inapplicable because FIAs are rarely securities.

However, unbeknownst to many financial planners, there is an insurance analogue in the case of annuity advisory services in roughly half of all U.S. jurisdictions. In other words, many financial planners fail to realize that the insurance producer license is not the only game in town; other insurance licensing requirements could potentially be triggered when a fee is received instead of a sales commission in connection with providing advice relative to annuities. Many financial planners (and perhaps even some insurance companies) presume the situation is as follows:






| Sale of Fee-Based Annuities | | |
|---|---|---|
| | **Sales Commision** | **Advisory Fee** |
| **Securities Licensing Requirements** | VAs – Series 6 or Series 7<br>FIAs – None (unless a security) | VAs – Series 65 or Series 66<br>FIAs – None |
| **Insurance Licensing Requirements** | VAs & FIAs - Insurance Producer | VAs & FIAs – None |

In fact, in many jurisdictions, there is once again a dual-licensing requirement for fee-based VAs and a state insurance licensing requirement for fee-based FIAs:

| Sale of Fee-Based Annuities | | |
|---|---|---|
| | **Sales Commision** | **Advisory Fee** |
| **Securities Licensing Requirements** | VAs – Series 6 or Series 7<br>FIAs – None (unless a security) | VAs – Series 65 or Series 66<br>FIAs – None |
| **Insurance Licensing Requirements** | VAs & FIAs - Insurance Producer | VAs & FIAs – Insurance Consultant (or Counselor, Adviser, or Analyst) |

As the National Association of Insurance Commissioners ("NAIC") explains in chapter 22 of its State Licensing Handbook:

> An insurance consultant is a person who charges a fee for giving advice about insurance products. Not all states require a separate consultant license. . . In states that do require a special license, the applicant is usually required to pass an examination . . . In all cases where an individual is acting as an insurance consultant, a written contract should be used to clearly explain the terms of the consultant arrangement. In states that have a separate insurance consultant license, it is a common practice to have a continuing education (CE) requirement that mirrors the CE requirement for insurance producers.[12]

Depending on the jurisdiction, an insurance consultant may also be known as an "insurance counselor," an "insurance adviser," or an "insurance analyst," but the concept is the same.

### Avoiding the Trap

At present, 27 jurisdictions have some form of statute or regulation—separate or distinct from that of insurance producers—for those who act as insurance consultants.[13] However, available exemptions and other requirements[14] differ across jurisdictions, so working with a knowledgeable insurance attorney is strongly recommended to ensure compliance with the insurance laws and regulations of the relevant jurisdiction.

Ultimately, those who wish to sell fee-based annuities have several options depending on their appetite for risk:

- *Low*: Limit the sale of fee-based annuities to only those jurisdictions that lack any form of insurance consultant regulation.
- *Medium:* Obtain the necessary insurance licensing so that fee-based annuities can be offered in any jurisdiction. However, in some jurisdictions, it may be necessary for both the IAR and the RIA to be licensed, which presents certain risks. For example, licensing an RIA as an insurance consultant will require updates to the RIA's Form ADV filings. In addition, even a small insurance fine exceeding $2,500 would trigger special notice (i.e., an "interim amendment") to all advisory clients,[15] a process that can be expensive and may result in reputational harm.
- *Unknown:* Offer fee-based annuities and take a wait-and-see approach. At present, the risk of enforcement appears low, as state insurance regulators are not actively enforcing insurance consultant licensing requirements despite the growing popularity of fee-based annuities. However, this enforcement posture could easily change in the future and without warning, making this approach aggressive with an unknown degree of risk.

If none of these options are satisfying, the industry is developing other novel solutions. These include working through a general agency, partnering with an insurance company that will shoulder the regulatory load,[16] or partnering with a third party.[17] To the extent these other arrangements might involve acting as a promoter[18] for an investment adviser, financial planners should keep in mind the requirements of Advisers Act Rule 206(4)-1 and registration requirements for solicitors under state securities laws.[19]

No matter what, innovation is sure to continue in this growing segment of the financial services industry. Whether insurance regulators will take notice and keep up, or turn to their enforcement toolbox, remains to be seen.

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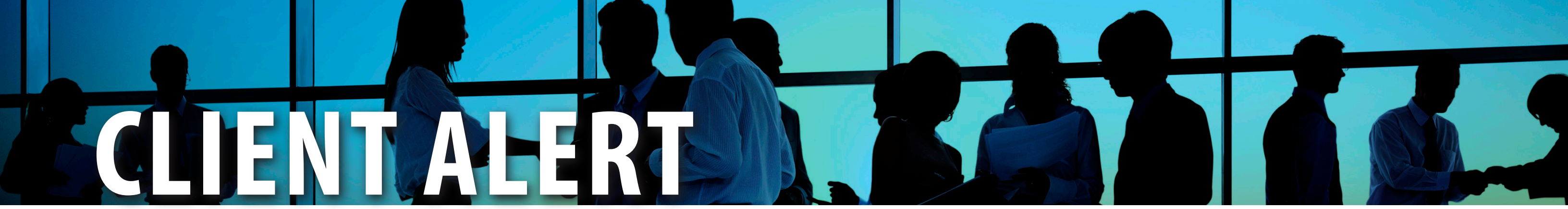




[1]Subject to certain conditions, Section 989J of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (P.L. 111-203) instructs the SEC to treat such annuities as exempt securities under Section 3(a)(8) of the Securities Act of 1933. As the SEC staff acknowledge, "Not all indexed annuities are regulated by the SEC. The SEC regulates only indexed annuities that are securities." Office of Investor Education Advocacy, *Updated Investor Bulletin: Indexed Annuities* (July 31, 2020), available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_indexedannuities.

[2]According to FINRA, "While all annuities are regulated by state insurance commissioners, variable annuities are also regulated at the federal level by the U.S. Securities and Exchange Commission (SEC) and FINRA." FINRA, *Investment Products: Annuities*, available at https://www.finra.org/investors/investing/investment-products/annuities.

[3]LIMRA, "Secure Retirement Institute: Total U.S. Annuity Sales Highest Since the Great Recession," *limra.com* (Mar. 10, 2022), available at https://www.limra.com/en/newsroom/news-releases/2022/secure-retirement-institute-investors-seeking-protection-and-greater-returns-propel-total-u.s.-annuity-sales-to-highest-since-the-great-recession/.

[4]It is estimated that by 2023, "93% of advisors across all channels expect to generate at least 50% of their revenue from advisory fees." Cerulli Associates, "RIAs Defend Marketshare with Service Expansion," *cerulli.com* (Mar. 1, 2022), available at https://www.cerulli.com/press-releases/rias-defend-marketshare-with-service-expansion.

[5]In 2016, the DOL revised its five-part test, first issued in 1975, describing what constitutes fiduciary investment advice under Section 3(21)(A)(ii) of ERISA. Under the 1975 standard, broker-dealers could receive commissions and other forms of compensation that are prohibited to ERISA fiduciaries because they generally were regarded as not providing fiduciary investment advice. Under the 2016 standard, however, broker-dealers were no longer able to receive commissions, load fees, or 12b-1 fees for their advice absent a prohibited transaction exemption. The 2016 standard was later vacated on appeal in 2018. *See Chamber of Commerce of the U.S. v. U.S. Dep't of Labor*, 885 F.3d 360 (5th Cir. 2018).

[6]*See, e.g.*, I.R.S. Priv. Ltr. Rul. 201946003, 2019 WL 6041780 (Aug. 6, 2019).

[7]*Id.*

[8]In 2015, FINRA reported 639,442 registered representatives at year-end. By 2021, that number had declined to 612,457. *See* FINRA, "Statistics," *finra.org*, available at https://www.finra.org/media-center/statistics#reps.

[9]Investment Adviser Association, *Investment Adviser Industry Snapshot 2021* (2d ed. July 2021), available at https://investmentadviser.org/wp-content/uploads/2021/08/Investment_Adviser_Industry_Snapshot_2021.pdf.

[10]Jackson National Life Insurance Company, "Fee-based annuity solutions," *jackson.com*, available at https://www.jackson.com/ria-and-wealth-managers/fee-based-annuity-solutions.html.

[11]According to the North American Securities Administrators Association ("NASAA"), most states will allow an individual to substitute one of the following certifications for passing the exam: (1) Certified Financial Planner (granted by the CFP Board of Standards); (2) Chartered Investment Counselor (granted by the Investment Adviser Association); (3) Chartered Financial Consultant (granted by the American College); (4) Personal Financial Specialist (granted by the American Institute of Certified Public Accountants); and (5) Chartered Financial Analyst (granted by the Chartered Financial Analyst Institute). *See* NASAA, "Exam FAQs," *nasaa.org*, available at https://www.nasaa.org/exams/exam-faqs/.

[12]NAIC, *State Licensing Handbook* (2020), available at https://content.naic.org/sites/default/files/inline-files/State%20Licensing%20Handbook%20-%20Complete%20and%20Final.pdf.

[13]These include Arkansas, California, Connecticut, Georgia, Indiana, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Dakota, Oklahoma, Oregon, Puerto Rico, Texas, Utah, Vermont, Virginia, and Wyoming.

[14]Depending on the jurisdiction, such requirements might include one or more of the following: (1) the use of a client contract that incorporates standard or mandated contract language, (2) submission of a client contract template to the state insurance regulator for pre-approval, (3) use of a mandated disclosure statement with clients, (4) a license examination for individuals, (5) experience qualifications and continuing education for individuals, (6) bonding and errors and omissions insurance, (7) record-keeping obligations, and (8) prohibitions against client loans or simultaneously holding a producer license.

[15]*See* General Instruction 2 and Item 9.B of Form ADV Part 2A.

[16]*See, e.g.*, Nationwide, "Nationwide Advisory Solutions Launches New Variable Annuity with Lifetime Income Guarantee Designed Expressly for RIAs and Fee-Based Advisors," *nationwide.com* (Mar. 13, 2019), available at https://news.nationwide.com/nationwide-advisory-solutions-launches-new-variable-annuity-with-lifetime-income-guarantee-designed-expressly-for-rias-and-fee-based-advisors/ ("For RIAs who don't hold an insurance license, Nationwide Advisory Solutions provides a licensed insurance agent service direct to the advisor and their client at no additional cost").

[17]*See, e.g.*, RetireOne, "Partner with Us," *retireone.com*, available at https://advisercounsel.net/2020/09/29/the-rise-of-fee-based-annuities-and-potential-licensing-issues-for-independent-investment-advisers/ ("Fee-only fiduciaries like you don't need to have insurance licenses to access our marketplace of no-load insurance + annuity solutions. We're the agent of record, and there's no additional cost to you or your clients."); DPL Financial Partners, "Solutions," *dplfp.com*, available at https://www.dplfp.com/solutions/for-your-practice ("RIAs join DPL to bring their clients' insurance under their fiduciary umbrella, provide solutions clients want and need, and grow their business").

[18]"While we traditionally referred to those who engaged in compensated solicitation activity under the current solicitation rule [former Advisers Act Rule 206(4)-3] as 'solicitors,' we use the term 'promoter' in this release to refer to a person providing a testimonial or endorsement, whether compensated or uncompensated. . . . The promoter may be an entity or a natural person." *Investment Adviser Marketing,* Advisers Act Release No. 5653, 86 Fed. Reg. 13024, 13025 n.6, 13048 n.293 (Mar. 5, 2021).

[19]Certain states that have adopted the Uniform Securities Act of 2002 define the term "investment adviser representative" to include solicitors, which is what promoters were called prior to the amendments to Advisers Act Rule 206(4)-1. *See,* e.g., MCL § 451.2101a(f) (Michigan law).