THE Committee OF Annuity Insurers
www.annuity-insurers.org

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Via E-Mail (NASAAcomments@nasaa.org)

Amy Kopleton
Broker-Dealer Market and Regulatory Policy and Review Project Group Chair
James Nix
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North American Securities Administrators Association, Inc.
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Washington D.C. 20002

Re: Proposed Revisions to NASAA's Dishonest or Unethical Business Practices of Broker-Dealers and Agents Model Rule

Dear Ms. Kopleton and Mr. Nix:

We are submitting this letter on behalf of the Committee of Annuity Insurers (the "Committee"),[1] in response to the North American Securities Administrators Association, Inc.'s ("NASAA") proposed amendments (the "Proposal") to its model rule on *Dishonest or Unethical Business Practices of Broker-Dealers and Agents* (the "Model Rule" or, as proposed, the "Proposed Model Rule").[2] The Committee appreciates the opportunity to comment on the Proposal.

The Committee supports the proposed incorporation of Regulation Best Interest's ("Reg BI") rule text into the Model Rule, which would have the effect of aligning the Model Rule with existing standards of care, and allow for a uniform approach by federal and state regulators examining broker-dealers' policies, procedures, and practices. However, the Proposal is problematic in that it seeks to expressly incorporate Securities and Exchange Commission ("SEC") staff guidance and NASAA's own guidance into the Proposed Model Rule, with the result that the Proposed Model Rule would impose a significantly different standard of care than the one imposed by Reg BI.

This result appears to be contrary to NASAA's stated intention to "align [the Model Rule] with the principles of Reg BI and incorporate the SEC's related interpretive guidance . . ." as well as provide NASAA's own "definitions and interpretations intended to fill certain gaps in SEC guidance."[3] Far from simply filling certain perceived gaps in Reg BI, many of NASAA's proposed

[1] The Committee is a coalition of many of the largest and most prominent issuers of annuity contracts. The Committee's 32 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 three 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 and 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* Proposed Revisions to NASAA's Dishonest or Unethical Business Practices of Broker-Dealers and Agents Model Rule (September 5, 2023), available here.

[3] *See* the Proposal at p. 3.

amendments would put the Model Rule in direct conflict with Reg BI and would require broker-dealers, in the states where it is adopted, to materially alter their policies, procedures, and practices related to how investment recommendations are made and conflicts of interest are addressed. Further, NASAA's presentation of the Proposal's amendments as a "menu of provisions" from which states can pick and choose would undoubtedly result in patchwork state regulation.

The Committee's comments describe the most consequential conflicts between the Proposed Model Rule and Reg BI. The Committee also provides commentary on NASAA's subjective and inaccurate categorization of variable annuities as "costly," "complex," and "risky" products, and its apparent use of that unsupported assertion to formulate the Proposed Model Rule. **Finally, the Committee highlights that, in most states, state insurance regulators have the sole and exclusive authority to regulate the issuance and sale of variable annuities and that a large number of states' securities laws expressly exclude insurance and annuity products from the definition of "security." In light of this, NASAA's emphasis on variable annuities is puzzling, considering that states' securities regulators in many cases lack regulatory authority over variable annuities.**

I. The Proposal Would Substantially Alter Broker-Dealers' Standard of Care

The Proposal sets forth a standard of care that is substantially different than the standard of care imposed by Reg BI and, therefore, would subject broker-dealers to requirements that have not been the subject of rulemaking by the SEC. Reg BI was the culmination of an intricate and deliberative rulemaking process, spanning approximately ten (10) years, that involved extensive consideration of comments and insights from a diverse set of stakeholders. The process began in 2010 with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which mandated that the SEC evaluate, and, if necessary, improve the standards of conduct for broker-dealers and investment advisers.[4] Pursuant to the Dodd-Frank Act, in 2011, SEC staff conducted a study to evaluate the effectiveness of existing standards of care and the potential need for enhanced regulations. The study recommended the adoption of a standard that would require firms "to act in the best interest of the customer without regard to the financial or other interest" of the broker-dealer.[5] In 2013, the SEC requested data and other information from the public to assist the SEC in evaluating whether and how to address standards of conduct for broker-dealers and subsequently received and evaluated more than 250 comment letters from industry groups and market participants.[6]

In 2018, the SEC proposed Reg BI and subsequently engaged in a 14-month process which included: (i) the consideration of approximately 3,000 unique comment letters from a variety of commenters including, among others, individual investors, consumer advocacy groups, financial services firms, and state securities regulators; (ii) the solicitation of individual investors' input at seven investor roundtables held in different locations across the country; and (iii) input and recommendations from the majority of the SEC's Investor Advisory Committee ("IAC").[7]

Since Reg BI's adoption in 2019, broker-dealers (including Committee members' affiliated broker-dealers) have spent considerable time and resources adopting and implementing policies,

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[4] *See* Section 913(g) of the Dodd-Frank Act.

[5] *See* Staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Jan. 2011), available here.

[6] *See Request for Data and Other Information: Duties of Brokers, Dealers, and Investment Advisers*, Exchange Act Release No. 69013 (Mar. 1, 2013), available here.

[7] *See* Regulation Best Interest, Securities Exchange Act Release No. 86031 (June 5, 2019), 84 Fed. Reg. 33318, 33320 (July 12, 2019), available here.

procedures, disclosures, and practices to comply with Reg BI and its component obligations. For this reason, the Committee would not object if NASAA simply incorporated Reg BI's rule text into the Model Rule. The Committee is concerned, however, with NASAA's proposed codification of SEC staff interpretive guidance around Reg BI into the Model Rule. This is problematic in that NASAA is attempting to give legal force and effect to guidance that was not intended for such a purpose. In their interpretive Staff Bulletins, SEC staff explicitly acknowledged that their guidance has "no legal force or effect, do[es] not alter or amend applicable law, and create[s] no new or additional obligations for any person."[8] While SEC staff interpretive guidance can offer valuable insights for the industry, it is not approved by the sitting SEC Commissioners and does not undergo the same notice and comment process as SEC rulemaking. The Committee is also concerned by NASAA's proposal of requirements that are substantially different from (i) Reg BI's rule text, (ii) guidance in the Reg BI Adopting Release (the "Reg BI Adopting Release"), and (iii) guidance in the SEC Staff Bulletins interpreting Reg BI. By incorporating its own interpretations and guidance into the Proposal, it appears that NASAA is attempting to fundamentally alter existing standards of care under Reg BI.

NASAA's approach is especially problematic in that it incorporates its own interpretations and SEC staff guidance through a series of "subparts," which it states are intended to serve as a "menu of provisions that NASAA members can use to define, clarify, or emphasize the obligations and component of Reg BI that matter most to each jurisdiction." Despite inviting states to pick and choose which subparts to adopt, which would undoubtedly result in each state ending up with a distinct standard of conduct, NASAA inexplicably argues that its approach "promot[es] uniformity." The Committee disagrees with this characterization, and believes that NASAA's framing of the Proposal in this manner explicitly eschews the concept of a uniform standard of care and actually promotes inconsistent and patchwork state regulation.

The Committee has outlined below the elements of the Proposal that, if adopted by NASAA (and later the individual states), would pose the greatest conflict with Reg BI and thus, the greatest difficulty for broker-dealers attempting to implement compliant policies, procedures, and practices. The Committee believes that the difficulty in complying with patchwork and inconsistent state standards of conduct that conflict with Reg BI would naturally lead to firms limiting the offering of certain products, which would have a corresponding negative impact on customer choice.

a. Compliance and Disclosure (Subpart 1d(1))

Subpart 1d(1) of the Proposed Model Rule would provide that "[t]he obligations set forth in this section cannot be satisfied through disclosure alone."[9] In its commentary associated with the proposed amendments, NASAA frames this provision as simply elevating SEC guidance from the Reg BI Adopting Release into rule text.[10] In reality, this language has far broader implications. While it is true that Reg BI as a whole cannot be satisfied through disclosure alone (*i.e.*, a broker-dealer cannot meet the care obligation solely through disclosure), broker-dealers *can* address certain conflicts solely through disclosure. The SEC explicitly acknowledges this fact in the Reg BI Adopting Release, noting "we generally believe that most firm-level conflicts can be addressed through appropriate disclosure."[11]

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[8] *See*, e.g., SEC Staff Bulletin, *Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations* at FN 1 (Apr. 20, 2023), available here.

[9] *See* Proposed Model Rule Subpart 1d(1).

[10] *See* the Proposal at p. 3.

[11] *See* 84 Fed. Reg. 33318 at 33393.

Therefore, if NASAA chooses to implement Subpart 1d(1)'s broad prohibition on disclosure, it would effectively embrace a provision that directly contradicts the very Reg BI guidance that it purports to incorporate. In the states where the Model Rule is adopted, broker-dealers may be required to abandon any disclosure approach to conflicts of interest that they developed under Reg BI.

b. Addressing Conflicts of Interest (Subpart 1d(2))

Subpart 1d(2) of the Proposed Model Rule would establish a presumption that conflicts must be "avoid[ed] or "eliminate[d]," and could only be addressed through disclosure and mitigation[12] if they "cannot reasonably be avoided or eliminated."[13] Similar to Subpart 1d(1), Subpart 1d(2) is in direct conflict with Reg BI, which allows broker-dealers to address most conflicts through disclosure and/or mitigation without first demonstrating that a conflict "cannot reasonably be avoided or eliminated." Further, although the Proposal aims to redefine how broker-dealers address conflicts of interest, it does not explain how a broker-dealer could establish that a "conflict of interest cannot reasonably be avoided or eliminated."

The Proposed Model Rule would also target standard broker-dealer compensation arrangements by establishing a presumption that a broker-dealer is placing its interests ahead of the interests of a retail customer if it receives compensation beyond sales commissions.[14] This presumption is, yet again, at odds with Reg BI. In the Reg BI Adopting Release, the SEC acknowledged that broker-dealers commonly receive financial incentives beyond sales commissions and, in doing so, noted that "[b]roker-dealers could meet the Disclosure Obligation by making certain required disclosures of information regarding conflicts of interest to their customers at the beginning of a relationship."[15] In the context of a mutual fund transaction where a broker-dealer may receive so-called "extra compensation," the SEC noted that

> a broker-dealer might disclose broadly that it is compensated by funds out of product fees or by the funds' sponsors, and that such compensation gives it an incentive to recommend certain products over other products for which the broker-dealer receives less compensation; later, when a broker-dealer recommends a particular fund, it could provide more specific detail about compensation arrangements, for example revenue sharing associated with the fund family.[16]

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[12] The amended Model Rule defines the term "mitigating a conflict of interest" as "neutralizing or reducing the potential for harm or adverse impact of the conflict to the retail customer." In this context, the work "neutralize" must have a different meaning than "eliminate" because firms can only mitigate a conflict if they cannot reasonably eliminate it. However, there is no context in the Proposal around how the concepts of "elimination" and "neutralization" differ in practice. The lack of explanation around this topic is of increased importance because of the SEC's recent rule proposal targeting conflicts associated with the use of predictive data analytics (the "SEC PDA Proposal"). Under the SEC PDA Proposal, broker-dealers would be required to address conflicts through "elimination or neutralization" rather than through "mitigation and/or disclosure." Based on a plain reading of the amended Model Rule against the SEC PDA Proposal, it appears that the SEC and the states have different interpretations of what it means to "neutralize" a conflict, which will necessarily result in regulatory confusion.

[13] *See* Proposed Model Rule Subpart 1d(2).

[14] NASAA justifies this presumption, which is not found in Reg BI or any SEC or SEC staff guidance, by noting that "extra compensation" beyond sales commissions is "not inherent to the broker-dealer business model." The only evidence cited for this conclusion is NASAA's own Phase II(A) Report. The Committee strongly disagrees with this broad and sweeping conclusion, and fails to see how NASAA reaches it based on the data gathered in its Phase II(A) Report.

[15] 84 Fed. Reg. 33318 at 33363.

While conflicts related to certain types of compensation arrangements are required to be disclosed under Reg BI (and, in some cases, mitigated or eliminated), there is no requirement that a broker-dealer "overcome a presumption" that it is placing its interests ahead of the interests of the retail customer by accepting said compensation, particularly where such compensation is a historically common practice. Further, because the Proposed Model Rule prohibits disclosure as a means to address conflicts, it is unclear how a broker-dealer could ever overcome such a presumption. The impact of this proposed change would be to remake the permitted, common compensation practices related to certain products to which the SEC and the National Association of Insurance Commissioners ("NAIC") have not objected.

This proposed presumption would be especially impactful for firms that transact solely, or primarily, in proprietary products issued by an affiliate given the typical compensation model in the proprietary distribution business model. When a proprietary product is sold, revenue flows both to the distributing broker-dealer and to the affiliated issuer. It is unclear under the Proposal whether an affiliated issuer's receipt of compensation related to the sale of a proprietary product would be the type of "extra compensation" that is targeted by the Proposed Model Rule.

Finally, the proposed presumption is problematic for insurance-affiliated broker-dealers that distribute their products through agents who are considered "statutory employees" under the federal tax code. Under the federal tax code, insurance-affiliated broker-dealers are permitted to provide health and welfare benefits to those agents (*i.e.*, health insurance, life insurance, 401(k)s), provided they meet certain annual sales/production requirements. The SEC and FINRA have long taken the view that standard employee benefit programs are a form of compensation that merits different treatment from other forms of cash and non-cash compensation arising from the sale of insurance products. This stance is rooted in their belief that regulations should not impose obstacles for employees in obtaining health and retirement benefits. For example, in the Reg BI Adopting Release, the SEC explicitly noted that it did "not intend to prohibit the receipt of certain employee benefits by statutory employees . . . as we do not consider these benefits to be considered non-cash compensation for purposes of Regulation Best Interest."[17] If NASAA chooses to adopt the proposed presumption, the Committee requests that NASAA explicitly exclude such employee benefits from the scope of the term "compensation."

c. Care, Skill, and Diligence (Subpart 1d(3))

Subpart 1d(3) of the Proposed Model Rule would introduce concepts not found in Reg BI related to the consideration of "reasonably available alternatives."[18] Under the Proposed Model Rule, broker-dealers would be required to "make reasonable inquiry regarding lower-cost and lower-risk securities and investment strategies that are reasonably available to the broker-dealer or agent, as well as products or services available if the agent is also [licensed/registered] in other capacities such as an investment adviser representative or insurance agent."[19] Under Reg BI, broker-dealers *are not* explicitly required to consider "lower-cost" and "lower-risk" securities while conducting a "reasonably available alternatives" analysis.

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[16] *Id.* at 33363.

[17] 84 Fed. Reg. 33318 at 33396; *See also* NASD Notice to Members 98-75, SEC Approves Rule Change Relating to Non-Cash Compensation for Mutual Funds and Variable Products (Sep. 1, 1998), available here ("The new term also includes cash employee benefits to make clear that certain payments of ordinary employee benefits as part of an overall compensation package are not included in the definition of non-cash compensation or governed under non-cash provisions.")

[18] *See* Proposed Model Rule Subpart 1d(3).

[19] The amended Model Rule set forth an exceedingly broad definition of "costs" which would include the "sum total of all potential fees and costs based on the anticipated holding period." Among other issues, this definition takes as a given that the projected costs to the investor can actually and consistently be knowable at the time of a recommendation.

The Proposed Model Rule would also expand the scope of products that a registered representative would be required to consider as part of a "reasonably available alternatives" analysis if the representative was also licensed as an investment adviser representative ("IAR") or insurance agent. This rule text seemingly exceeds SEC guidance in the Reg BI Adopting Release, which notes that "an evaluation of reasonably available alternatives does not require an evaluation of every possible alternative (including those offered outside the firm) . . ."[20] This is yet another area where NASAA purports to incorporate SEC guidance under Reg BI, but instead proposes to impose an obligation that is fundamentally different.

d. Recommendations (Subpart 1d(5)) and Retail Customer (Subpart 1d(6))

Subpart 1d(5) would define the term "recommendation" to include "any means, method or mechanism to feature or promote an account type, specific security or investment strategy to a retail customer . . ."[21] This definition exceeds any definition or interpretation of the term "recommendation" under Reg BI and/or related guidance.[22] It is drafted in such a broad manner that it could encompass virtually any method a broker-dealer might use to present a product, strategy, or account type to a retail customer, including product illustrations, educational materials, and even very general advertising promoting brand awareness and recognition of securities products being offered.

This definition is especially troubling when read in tandem with the proposed definition of a "retail customer," which includes "current and prospective customers and clients . . . ." The definition is fundamentally different from the definition of a "retail customer" in Reg BI, and coupled with NASAA's broad definition of "recommendation," broker-dealers could be deemed to have provided recommendations to non-customers simply by issuing marketing material which discusses an "account type, specific security or investment strategy." This is extremely problematic in that it potentially subjects broker-dealers to standard of care violations in situations where the broker-dealer did not provide any individualized investment recommendation. The Committee requests that NASAA amend the Proposal to align the definitions of "recommendation" and "retail customer" with the meaning ascribed to those terms by Reg BI.

II. NASAA's Reg BI Reports Have Misclassified Variable Annuities as a "Complex, Costly, and Risky Product."

NASAA justifies the Proposal, in part, on reports issued by its Regulation Best Interest Implementation Committee as a result of a coordinated examination initiative. In its commentary associated with the Proposal, NASAA frequently cites to its National Examination Initiative Phase II(A) Report (the "Phase II(A) Report") and Phase II(B) Report (the "Phase II(B) Report") (collectively referred to as the "Reports") that were respectively issued in November 2021 and October 2023.[23] The Reports focused on what NASAA referred to as "complex, costly, and risky" products (defined by NASAA as "CCR products"), and, more specifically on four product types: private securities, variable annuities, non-traded REITs, and leveraged or inverse ETFs.

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[20] 84 Fed. Reg. 33318 at 33326.

[21] *See* Proposed Model Rule Subpart 1d(5).

[22] The SEC has interpreted the term "recommendation," under Reg BI to include communications that "reasonably could be viewed as a 'call to action.'" The SEC has further provided that "[t]he more individually tailored the communication to a particular customer or a targeted group of customers, the greater the likelihood that the communication may be viewed as a 'recommendation.'" *See* Frequently Asked Questions on Regulation Best Interest, available here.

[23] *See* Phase II(A) Report, available here, and Phase II(B) Report, available here.

The Committee takes issue with NASAA's unsupported categorization of variable annuities as a "CCR product." While NASAA's subjective attack on variable annuities is troubling in and of itself, even more troubling is that NASAA relies on the Reports to justify the broad and sweeping changes in the Proposal to the broker-dealer standard of care. Because NASAA used the Reports to draft the Proposal, some of the proposed rule changes appear to implicitly target CCR products and the business models that support the sale of said products. This approach is deeply flawed.

NASAA does not define the terms "complex," "costly," or "risky" in the Reports, nor does it provide any explanation as to the characteristics that would make a securities product "complex," "costly," or "risky." Instead, NASAA subjectively categorizes specific products, such as variable annuities, as "CCR products" based on a misinterpretation of FINRA's 2020 Dispute Resolution Statistics and an unsupported assertion that the subjectively chosen products "routinely appear in investor complaints and state enforcement actions."[24] The Committee is compelled to address this assertion because, while NASAA presumably has access to abundant data from state securities regulators, it does not cite any evidence or data indicating the frequency with which variable annuities (or other "CCR products") appear in investor complaints or state enforcement actions.[25] In fact, NASAA does not even attempt to define what the term "routinely appears" means in this context.

Instead of collecting and analyzing data from its members to help draw conclusions as to the product types that would be appropriately categorized as "complex," "costly," and "risky," NASAA relies entirely on a subset of data from FINRA's 2020 Dispute Resolution Statistics regarding the "Top 15 Security Types in Customer Arbitrations." NASAA appears to make the argument that certain products should be labeled as "complex," "costly," and "risky" based on the number of times they appeared in customer arbitrations. This conclusion is flawed, and actually undermines NASAA's characterization of variable annuities as a "CCR product." First, this data takes into account all filed customer arbitrations, not just those customer arbitrations that resulted in an award or favorable result for the Claimant. Put simply, just because a customer arbitration is filed does not mean that the allegations therein have any merit. Second, "variable annuities" are ranked 11th on the "Top 15" list, behind real estate investment trusts, common stock, business development companies, private equities, options, mutual funds, municipal bonds, limited partnerships, municipal bond funds, and exchange-traded funds.[26] NASAA curiously does not categorize many of these product types as "complex," "costly," and "risky," despite the fact that they appeared in customer arbitrations more often than variable annuities. This further highlights that NASAA's targeting of variable annuities is entirely subjective, and is not backed by any conclusive evidence or data.

III. In the Majority of States, Variable Annuities Are Not Regulated By State Securities Regulators.

The Committee is compelled to comment on the Proposal because it proposes a standard of care that is fundamentally different than Reg BI, and it is based, at least in part, on the subjective and incorrect categorization of variable annuities as a "CCR product." Notwithstanding its comments on the Proposal, the Committee notes that (1) a large number of states' securities laws expressly exclude insurance and annuity products from the definition of "security," meaning that these products are not subject to the jurisdiction of state securities regulatory authorities, and/or (2) most states' insurance laws grant the state insurance regulatory authority the sole and exclusive authority to regulate the issuance and sale of variable annuities. As a result, although

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[24] *See* Phase II(A) Report at p. 6.

[25] To the extent that NASAA has gathered data reflecting that variable annuities "routinely appear" in state enforcement actions and customer complaints, the Committee would welcome an opportunity to review the data and engage in a dialogue with NASAA.

[26] *Id.*

the Committee appreciates the opportunity to comment on the Proposal, it does not concede that state securities regulators have the jurisdiction or authority to regulate variable annuities or variable annuity sales practices in most states.

In all states, variable annuity products are regulated by the state's insurance regulatory authority. Under the NAIC Suitability in Model Regulation (Model 275), all recommendation 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.[27] To date, at least 40 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.

In the Reports, NASAA focuses on variable annuities, among other products, and suggests amendments to the Model Rule based on its findings. However, it seems to overlook the limited regulatory authority of many of its members over variable annuities, and ignores that variable annuity sales practices are subject to robust regulation under all state's insurance laws.

CONCLUSION

The Committee appreciates the opportunity to provide these comments on the Proposed Rules. 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.

Respectfully submitted,

Eversheds Sutherland (US) LLP

FOR THE COMMITTEE OF ANNUITY INSURERS

cc: Stephen Bouchard (Former Chair, Broker-Dealer Section)

[27] 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.