

Fixed indexed Annuities: Disclosure and Other Fiduciary Requirements for RIAs

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Fixed indexed annuities (FIAs), previously known as “equity indexed annuities” (EIAs) are complicated investment products. While in concept FIAs could be part of an RIA’s arsenal of investment tools, in practice their high fees and costs, inherent complexity, and poor sales disclosures present real challenges for their utilization by fiduciary advisors. After reviewing the present regulatory landscape for FIAs, Ron explores in this One-Man Think Tank column various aspects of due diligence and disclosures involving sales or recommendations of FIA products by unlicensed investment advisers or by licensed RIAs.

Fixed indexed Annuities (FIAs) are now the preferred name for Equity Indexed Annuities (EIAs). Which brings to mind the saying – if you put lipstick on a pig, it’s still a pig.

Perhaps I’m being a bit too harsh. In theory, providing an investment product which possesses only positive returns (if one ignores surrender fees) and which participates (at least to a small degree) in stock market index returns sounds like a good idea. Unfortunately, due to lax insurance sales practices regulation and the inherent complexity of FIAs, many individual investors in fixed indexed annuities suffer real harm – and real losses. In essence, the “theory” of FIAs often fails in its execution, due to poor product design and abusive sales practices.

The Inadequate Current Regulation of FIAs.

Under intense pressure from the powerful insurance lobby, the Dodd Frank Act overturned the SEC’s decision to regulate FIAs as securities, returning their oversight to state insurance commissioners. Unfortunately, state oversight of insurance sales has focused mainly on capital requirements, not on sales practices and disclosures. And the legal standard against which a sale of an insurance product is measured has typically that of a weak form of suitability, one in which the sales agent had to only obtain information about a consumer’s financial status, tax status, and investment objectives before making a recommendation to the consumer.¹

¹ The 2006 version of the NAIC Model Regulation required that, prior to recommending an annuity, a producer or an insurer make reasonable efforts to obtain information about the consumer’s financial status, tax status, and investment objectives, as well as other information that could be used in making a recommendation to the

All of that may be changing, albeit very modestly. In 2010, the National Association of Insurance Commissioners (NAIC) adopted the 2010 Suitability in Annuity Transactions Model Regulation.² This regulation, likely to be adopted by many of the states over time, closely tracks the language of the “Senior Protection in Annuity Transactions Model Regulation” adopted several years earlier. Under this regulation, an insurance agent must gather certain information³ and must possess “reasonable grounds” to believe the transaction being recommended to the consumer is “suitable.” Broker-dealers may elect to subject FIA sales to FINRA suitability rules; sales made in compliance with FINRA rules are deemed to qualify as complying with the NAIC suitability regulation. Indeed, the 2010 NAIC model regulation is patterned after FINRA Rule 2330.

consumer. Some states, such as Florida, Indiana, and Arkansas, already impose higher suitability requirements, tracking the 2010 Model Rule’s requirements, on sales of annuities to seniors.

² The 2010 Suitability in Annuity Transactions Model Regulation provides in pertinent part: “Section 6. Duties of Insurers and of Insurance Producers.

A. In recommending to a consumer the purchase of an annuity or the exchange of an annuity that results in another insurance transaction or series of insurance transactions, the insurance producer, or the insurer where no producer is involved, shall have reasonable grounds for believing that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer as to his or her investments and other insurance products and as to his or her financial situation and needs, including the consumer’s suitability information, and that there is a reasonable basis to believe all of the following:

(1) The consumer has been reasonably informed of various features of the annuity, such as the potential surrender period and surrender charge, potential tax penalty if the consumer sells, exchanges, surrenders or annuitizes the annuity, mortality and expense fees, investment advisory fees, potential charges for and features of riders, limitations on interest returns, insurance and investment components and market risk;

(2) The consumer would benefit from certain features of the annuity, such as tax-deferred growth, annuitization or death or living benefit;

(3) The particular annuity as a whole, the underlying subaccounts to which funds are allocated at the time of purchase or exchange of the annuity, and riders and similar product enhancements, if any, are suitable (and in the case of an exchange or replacement, the transaction as a whole is suitable) for the particular consumer based on his or her suitability information; and

(4) In the case of an exchange or replacement of an annuity, the exchange or replacement is suitable including taking into consideration whether:

(a) The consumer will incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living or other contractual benefits), or be subject to increased fees, investment advisory fees or charges for riders and similar product enhancements;

(b) The consumer would benefit from product enhancements and improvements; and

(c) The consumer has had another annuity exchange or replacement and, in particular, an exchange or replacement within the preceding 36 months.”

³ Section 5I of the 2010 Model Regulation defines “suitability information” to mean information that is reasonably appropriate to determine the suitability of a recommendation, including the following: (1) Age; (2) Annual income; (3) Financial situation and needs, including the financial resources used for the funding of the annuity; (4) Financial experience; (5) Financial objectives; (6) Intended use of the annuity; (7) Financial time horizon; (8) Existing assets, including investment and life insurance holdings; (9) Liquidity needs; (10) Liquid net worth; (11) Risk tolerance; and (12) Tax status. These are the same 12 factors found in FINRA Rule 2330(b)(2).

Of course, “suitability” – even in the model regulation – is a very weak standard⁴ to which sellers of annuities – whether they be insurance agents or registered representatives – must hold themselves. Moreover, suitability’s focus is mostly on risks; the seller of a product operating under the suitability standard possesses little responsibility to ensure that the fees and costs associated with the product are low, nor to ensure that the product is best for the customer’s current tax situation.

Are Sales of FIAs by Insurance Agents Subject to RIA Registration Requirements?

"If the [insurance only] agents are advising people to sell mutual funds or get out of 401(k)s, they are acting as investment advisers. And in my state, being an unregistered investment adviser is a felony." So stated Joseph Borg, Alabama Securities Commissioner and Past President of the North American Securities Administrators Association, in the *Wall Street Journal* on August 8, 2007.

Many state securities administrators are attacking sales of FIAs by insurance agents as the provision of investment advice. Under the Investment Advisers Act of 1940 (and parallel state acts following the Uniform Securities Act), if a life insurance agent provides “advice” concerning “securities,” the insurance-only agent needs to be concerned that they are giving investment advice. Such may occur if the insurance agent is recommending that the customer sell a mutual fund, stock, bond, or any other security in order to purchase a fixed annuity. Hence, unless the insurance only agent is telling the customer to invest cash funds, or is advising the customer to exchange a current insurance product for a FIA, that insurance agent will most likely be considered giving investment advice as defined by the Advisers Act.

Several recent enforcement proceedings illustrate the long arm of the state securities regulators.

For example, an August 2010 order entered by the Secretary of State of Illinois noted that an insurance agent invested a 75-year-old elderly couple’s entire \$800,000 stock and bond portfolio into equity indexed annuities “with surrender periods during which time access to their money would be limited ... The concentration in equity index annuities were unsuitable and contrary to the customer’s investment objectives. The sales generated excessive amounts of commissions” It was also alleged that the

⁴ See James J. Angel, Ph.D., CFA, and Douglas McCabe Ph.D., McDonough School of Business, Georgetown University, “Ethical Standards for Stockbrokers: Fiduciary or Suitability?” (Draft 1.05, Sept. 30, 2010), describing the suitability standard under FINRA Rule 2330 as a “weak” standard and providing the following further explanation: “[T]he current [FINRA] rule has two major parts. The first part is that the broker has ‘reasonable grounds’ to believe that the recommended security is suitable. The second part imposes an affirmative obligation on the broker to find out information from the client to be able to make a suitable recommendation ... sellers do not necessarily have to tell the customer that another seller has a better one for sale at a lower price. In short, *caveat emptor*. It is the buyer’s responsibility to shop around for the best price.” The authors also posit a view on why commissioned-base product sales still dominate the financial services landscape: “[D]ifferent products require different degrees of effort to get sold, which means different levels of commissions and profitability to the distribution channels. Issuers thus prefer a commission-based distribution channel because of its ability to move the product. Alas, the most appropriate solution for the issuers is fraught with conflicts of interest for the investors, as we have seen. This is a type of ethical pollution that motivates unethical behavior for financial gain.” [Professor Angel’s and McCabe’s paper can be found at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1686756.]

insurance agent switched the annuities, and “failed to disclose the existence of commission charges, surrender penalties, tax liabilities associated with the products, as well as the illiquidity of the money placed into the annuities” and that the customer “as a result suffered a \$150,000 loss to their portfolio.”⁵

More recently, the State of Missouri’s Secretary of State issued a Cease and Desist Order against a dually licensed investment adviser representative (IAR) and insurance agent who gave luncheon seminars promoting sales of FIAs. Secretary Carnahan also sought substantial fines for violations of securities law, including breach of the IAR’s fiduciary duties. The Order to Show Cause alleged: “[The IAR/insurance agent] encouraged investors to sell their securities and/or annuities and take surrender penalties in order to purchase equity index annuities (‘EIAs’). [He] also stated that the bonus feature of the EIA would pay for the surrender fees and investors would never lose money investing in an EIA ... During his seminars, [the IAR] usually discussed the volatility of the markets, highlighting both the risks involved with investing in the markets and the various costs associated with mutual funds, stocks, bonds, and variable annuities. [The IAR] would contrast the volatility and costs associated with investments in the market with features of fixed annuity and EIA investments that he claimed would provide safety and remove market risk ... [the] seminar invitation also marketed his credentials by prominently displaying [his] IAR designation ... website also touted [the IAR’s] credentials and experience ... The [firm’s] website stated that [the IAR’s] goal was “to be the most comprehensive retirement planner and investment advisor [sic] based upon [his] experience, professional judgment [sic] and skills.” The website also stated that, since 1995, [the IAR] has been “providing [his] clients with unbiased and independent financial advice.”

Secretary Carnahan’s Order to Show Cause also alleged: “While [the IAR’s] marketing materials and website stated and [his] seminar presentations talked about the importance of having a financial plan in place and the subtle differences between a stockbroker (broker-dealer agent) and ‘Independent Investment Advisor,’ the only products [the IAR] promoted were fixed and indexed annuities, which are insurance products. [The IAR] promoted these insurance products without thoroughly detailing the potential benefits or risks the annuities may have in comparison to the benefits and/or risks of other investment vehicles, such as CDs, stock, bonds, mutual funds, or variable annuities.” In connection with an exchange from one annuity to a new EIA, the Order also stated: “Although ... as an IAR [he] had a fiduciary duty to [the client], [the IAR] did not explain ... that a lifetime income stream could also be obtained by either taking systematic monthly withdrawals or ‘annuitizing’ [the] current ... annuity ... Had [the client] either annuitized or established a systematic monthly withdrawal from [the prior EIA, the client] could have avoided surrender penalties and a new surrender period applicable to the [new] EIA recommended by [the IAR] ... Instead of recommending other less costly and less restrictive products that provide similar returns to the fixed accounts of the annuities sold, such as CDs, traditional fixed annuities, or recommending that clients place their money in the fixed accounts of existing annuities,

⁵ The Illinois Secretary of State’s Order can be found at http://www.cyberdriveillinois.com/departments/securities/administrative_actions/2010/august/jefferyhum_op.pdf.

[the RIA] recommended and sold annuity products in which he would obtain a substantial commission and subject the client to surrender penalties, additional surrender periods, and/or higher costs.”⁶

The Missouri case is revealing as Secretary Carnahan alleges that the IAR/insurance agent committed multiple breaches of his fiduciary duty to his clients by “failing to provide financial recommendations that were in the best interests of his clients” ..., “recommending and selling unsuitable products through which he made substantial commissions after leading his clients to believe that he was acting in their best interests” ..., and “failing to provide written disclosure of the commissions [he] made on the sale of the insurance products.”

The Missouri case is also notable for the alleged breaches of the fiduciary duty of loyalty, inadequate disclosures of compensation arrangements, and failure to undertake due diligence required to uncover (and then disclose) the limitations of the FIA. But the foregoing cases are not isolated examples. Numerous other states have in recent years sought enforcement actions against unlicensed investment advisers, and against licensed investment advisers, for breach of their fiduciary duties involving sales of FIAs. Moreover, some states and private securities litigation attorneys have also pursued individual or class actions against insurance companies for promoting improper sales of fixed annuity products by their agents.⁷

A “Safe” Investment?

“Indexed annuities are one of the safest ways for retirees to allocate their money to make sure they have retirement income,” stated the owner of a one financial planning firm recently.⁸ Does such a claim survive intense scrutiny? While the “insurance” features of an FIA provide a measure of “safety,” there are nevertheless many risks present with FIAs, including risks associated with possible insurance company default, changes in caps or participation rates or administrative fees (thereby affecting future rates of return within the FIA), and risks resulting from loss of liquidity (due to the presence of surrender fees).

⁶ The Missouri Order to Show Cause can be found at <http://www.sos.mo.gov/securities/orders/AP-10-45.asp>.

⁷ See, e.g., Robinson, “Annuity Class Action Litigation—Trends and Strategies for Effective Class Action Defense,” Life, Health, Disability and ERISA Claims Seminar, April 2009 (available at http://www.dri.org/ContentDirectory/Public/CommitteeDocs/0055/Annuity_Class_Action.pdf), noting that “Companies selling annuities must develop a strategy for addressing proactively the government’s heightened interest in pursuing costly investigations into the sale of annuities and the boom of private class action litigation challenging annuity sales.” See, e.g., Robinson, “Annuity Class Action Litigation—Trends and Strategies for Effective Class Action Defense,” Life, Health, Disability and ERISA Claims Seminar, April 2009 (available at http://www.dri.org/ContentDirectory/Public/CommitteeDocs/0055/Annuity_Class_Action.pdf), noting that “Companies selling annuities must develop a strategy for addressing proactively the government’s heightened interest in pursuing costly investigations into the sale of annuities and the boom of private class action litigation challenging annuity sales.”

⁸ Quoting the owner of a dual registrant and insurance sales-licensed financial planning firm in an article written by Daisy Maxey, “Some Dismayed by Indexed-Annuity Regulation,” *Wall Street Journal* (July 19, 2010), available at <http://online.wsj.com/article/SB10001424052748703722804575369463923411750.html>.

Required Due Diligence.

A fiduciary advisor is subject to the fiduciary duty of due care, which encompasses due diligence. This fiduciary duty involves the duty to both discern and disclose all of the material facts when undertaking an investment recommendation to a client. Of course, the risks, fees and costs associated with FIAs are all certainly material facts, which should be ascertained and fully disclosed to clients.

The first requirement for any RIA is to understand all of the features and characteristics of any annuity contract to be recommended to a client. This enables the RIA to not only contrast one product against another (i.e., a step involved in appropriate investment product due diligence), but also to discern whether the investment strategy offered by any FIA is itself appropriate.⁹

Common Characteristics of FIAs.

An equity-indexed annuity is an annuity that earns interest or provides benefits that are linked to an external equity reference or an equity index. The value of the index is often tied to a stock or other equity index, the most common being the S&P 500. Equity-indexed annuities promise to pay a minimum interest rate, with the minimum interest rate to apply, even if the index-linked interest rate is lower.

Subject to costs associated with early redemptions, the value of the FIA is said to not drop below a guaranteed minimum. For example, many FIAs guarantee the minimum value will never be less than a certain percentage of the premiums paid, less withdrawals, plus a minimum annual interest rate (typically now 1% to 2%, although older policies often guaranteed 3%).

"I Wouldn't Recommend Them to Anybody." Given the seemingly positive features previously described, why would Alabama Securities Commissioner Joseph Borg opine on *Dateline NBC* in 2008, when asked if he would recommend an equity indexed annuity to his own mother: "I wouldn't. I wouldn't recommend them to anybody."¹⁰ And why do so many state securities administrators issue "alerts" regarding fixed indexed annuities?¹¹

⁹ For a discussion of investment strategy due diligence, see Rhoades, "One-Man Think Tank: Would your investment strategy stand up in court?" (RIA Biz, 2010), available at <http://riabizdev.appspot.com/a/3231037>.)

¹⁰ Jeffrey D. Voudrie, "The Wolf Among the Lambs - I Warned You About Indexed Annuities," available at SeniorJournal.com: <http://seniorjournal.com/NEWS/GuardWealth/2008/8-04-28-TheWolfAmongTheLambs.htm>.

¹¹ See, e.g., "Equity Indexed Annuity Alert" issued by the Florida Department of Financial Services, available at http://www.myfloridacfo.com/consumers/guides/life/annuity_alert.htm, and noting: "In reality, equity indexed deferred annuities are extremely complex investment products and can contain many detrimental features such as hidden penalties, costs fees, and massive, multi-year surrender charges ... Before investing in any deferred annuity, investors should have an understanding of the true terms and conditions and any potential financial consequences associated with that purchase. A prospective investor should understand: (1) the overall product features of that annuity; (2) the tax impact that annuity may have for the investor and beneficiaries; (3) the projected rates of return and the certainty of those rates; (4) the liquidity of the investment; (5) the age the annuitant must reach

The answer lies in the many potential negative attributes of fixed indexed annuities, as they currently exist in the marketplace today. Following is a discussion of potential “downsides” of FIAs, many of which are unlikely to be fully disclosed by insurance agents selling these complex products – at least in terms the customer can understand.

The Index – Exclusion of Dividends. FIAs credit the investor a certain rate of return which is often based upon the change in the level of a stock price index. Most FIAs include the S&P 500 Index; Standard and Poors reports that over 92% of FIA products offer accounts linked to the S&P 500. At times multiple indices are offered and FIA contract owners may choose (usually annually) as to how to allocate the cash value between the various index accounts and a “fixed account.”

However, the indexes used in FIAs are (usually) “price appreciation” indexes only. These indexes do not include the impact of dividends, which would normally be reinvested in an index stock mutual fund. Accordingly, when contrasting stock index returns to FIAs, investment advisers should utilize the “total return index series” (which includes reinvested dividends) calculated for the S&P 500 Index, rather than the “price return index” (which excludes dividends) commonly utilized for FIA interest crediting purposes.

How important are dividends to the total return of the S&P 500 Index? From the beginning of 1950 through the end of 2009, the average annual dividends of the S&P 500 Index were about 3.6%. However, in the 1990’s average dividend rate had declined to 2.7%, and the 2000’s average dividend rate was only 1.8%.¹² While the dividend rate on the S&P 500 has been significantly lower during the past two decades than in prior periods, the future of dividend rates is uncertain. Due to differences in tax policies in the United States (as to whether dividends receive preferential tax treatment), and more importantly corporate and investor attitudes on the importance of dividend payouts (versus retaining capital and using same in the firm for expansion, stock buy-backs, or other uses), predictions of the future of dividend payouts in the United States are inherently uncertain. Rises in the dividend rate would further impact a consumer’s ability to share in the appreciation of indices.

Assuming future returns of the S&P 500 Index are similar to long-term historical total returns – which includes reinvested dividends, and assuming the dividend yield of the index may range from a low of 1.5% to perhaps as high as 3% on average in future years, this means that anywhere from 11% to 29% of the annual return of the S&P 500 index are not included in the calculation and lost to the investor, purely as a result of this one factor – no inclusion of reinvested dividends. This tends to understate the

before being eligible to receive regular annuitization payments without penalty; and (6) all of the fees and costs associated with that product.”

¹² Data per chart at <http://www.simplestockinvesting.com/SP500-historical-real-total-returns.htm#inflation-dividends>. The author notes that dividend distribution rates are estimated. Per data obtained from Robert Shiller’s site, as of December 2010 the annualized dividend rate for the S&P 500 was 1.83%. The annualized dividend rate had reached 3.6% in March 2009, when stock values were near their low during the recent recession.

true impact on average annualized returns to the consumer over long periods of time, due to the effects of compounding, which magnifies even small differences between “price-only” total returns and “dividends-reinvested” total returns over long periods of time. For example, an investment in the S&P 500 price-only index in January 1975 (assuming no fees, costs, taxes or limitations) would have yielded a total return of 1,801% through December 2007. In contrast, an investment in the S&P 500 index with dividends included and reinvested would have yielded a total return of 5,995%.

Differences in the Index Crediting Method Can Affect Returns. There are three common formulas, called indexing methods, used to translate changes in the index level into gross returns for the index account of the FIA. In some cases, investors may be able to choose the method by which interest will be credited to the FIA. Common methods of interest calculation include “high water mark,” annual ratchet, and one-year or two-year point-to-point averaging.

Under the “high water market” method, interest is credited only once, at the end of the contract, based on the percentage increase between the beginning index number value and the highest index number attained at some point during the contract term. This high-water-mark (or “look-back”) method looks at the index at specific points during the term, such as each anniversary date), and the highest index value at these points is then compared with the index value at the beginning of the term. This could result in a higher interest rate than the point-to-point method if the index has moved downward towards the end of the term. With this method, interest is added to the value of the FIA at the end of the term. As a result, compounding of interest within the contract may not occur.

The “annual ratchet” method usually credits an amount of interest based on any increase in value of the underlying index from the beginning to the end of the year. Once credited to the FIA, the interest is locked in.

The “point-to-point method” measures the increase in the index level from the beginning to the end of the period chosen. For example, if the index level was 1,000 on the contract date, and 1,100 at the end of the chosen term, the point-to-point method records a 10% increase. The “term” chosen can vary, ranging from monthly to annually to 2-year terms or even longer. A new “base” occurs with each new term.

The “monthly average return method” is more complicated, as it calculates the increase in the index level from the start of each period to the average month-end level during the period. Monthly averaging systematically understates the increase in the level of the index. Where the value of the index rises steadily, the expected index change with monthly averaging may be less than half the expected change calculated by the traditional point-to-point method when the term is defined as one year or longer.

All things being equal, policies with “point-to-point methods” are generally more valuable than those which utilize “monthly average return methods,” at least for terms of one year or longer. However, as further discussed below, FIAs which utilize point-to-point methods of some form are more likely to

possess other adverse features, such as lower participation rates or retention by the insurance company to change interest rate caps, participation rates, or administrative charges.

The Interest Rate Cap Can Substantially Limit Returns. With an FIA, the investor should not assume that he or she will be receiving a return on the invested funds that is comparable to the return achieved by the underlying index. This is because FIAs set a maximum rate of interest that an investor will receive, even if the underlying stock market index performs well. For example, if an FIA has a “cap,” or upper limit of 6%, and the underlying index earns 20%, the maximum the investor will be eligible to receive is still only 6%. Worse yet is the common feature – despite the “fixed” nature of the annuity – that insurance companies reserve the right to reduce the interest rate cap on previously issued FIA contracts.

The Participation Rate Limits Returns. Even when the underlying index earns a return of 20%, the interest credited to the equity indexed annuity may not be calculated based on that 20% return. The term “participation rate” is used to describe how much of the increase or return of the underlying stock market index will be used to calculate the return. For example, if a participation rate is 70%, and the index increases 20%, the return credited to the equity indexed annuity would be only 14% ($20\% \times 70\% = 14\%$). Participation rates vary among EIAs, but rates of 70 percent to 90 percent are typical. Also note that some companies reserve the right to lower participation rates for their already-issued FIAs in future years.

Market Value Adjustments Can Further Reduce Interest Credits. Some FIAs include a feature known as a “market value adjustment.” This may be a complex formula that is difficult to understand, but market value adjustments typically function to alter or reduce the cash value of an annuity dependent on changes in the interest rate since the contract’s issue. Such adjustments may result in a partial or full loss of any previously credited bonuses or interest credits, and potentially, may also result in loss of premium during the surrender period years.

“Administrative Fees” Can Also Eat Into Returns. Some FIAs contain an “administrative fee” that amounts to the difference between the percentage gain in the index and the actual amount credited to the investor. The difference, which may also be called a “spread” or “margin,” is retained as an asset fee or administrative charge by the company. Some FIA contracts allow companies to increase administrative fees at some future time.

The administration fee is a percentage that is subtracted from the index's gain. For example, if the administration fee is 2 percent and the index increases 8 percent, the interest rate would be 6 percent ($8 - 2 = 6$). If there is also a participation rate of 90 percent, the interest rate would be 5.4 percent ($[(8 - 2) \times .9 = 5.4]$). As with other inherent limitations on future returns, these fees are not always disclosed clearly in marketing materials or in contracts, but may be “implied” based on index crediting methods.

The Often-Overlooked Surrender Fees. Surrender charges may vary dramatically among FIAs, and can be as high as 25% and last as long as 20 years. While most deferred annuities carry surrender charges, FIAs typically possess surrender charges that are higher, and last for periods longer, than traditional fixed or

variable annuity products. As a result, funds withdrawn from an annuity prior to the expiration of the contract's surrender charge period may be subject to hefty surrender fees. Most of the new clients to this author's firm, as to those who already own FIAs when they come to see us, are unaware of the surrender fees, as they are often buried in the fine print of the annuity contract and/or may be difficult to discern.

Life Insurance Company Solvency. Fixed indexed annuities represent general obligations of the insurance company, and therefore the solvency of the FIA issuer is a key concern. In recent years, a number of insurance companies have become insolvent, leaving their policyholders with no coverage (or coverage only from a government-backed insurance pool or other arrangement with less attractive payouts for losses). While a number of independent rating agencies provide information and rate the financial viability of insurance companies, a close review of default rates based upon ratings in prior years reveals that "safety" is likely only present among a core group of extremely highly-rated, large insurance companies. While the impaired financial strength of several large insurance companies during the recent recession is fresh in the minds of many investment advisers, the situation has occurred even in periods of relatively good economic growth. As stated in a Moody's 1999 report: "During the early 1990's several high profile life insurance companies were placed into rehabilitation by insurance regulators due to solvency concerns, shocking an industry that markets itself as strong, stable and predictable."¹³ The risk of insurance company default can perhaps be minimized through efforts to diversify FIA purchases among several major, highly-rated insurance companies, but cannot be effectively negated in its entirety and remains a risk to the consumer which must be disclosed. This is especially true given recent tax reform proposals which, if enacted (more likely in a period where large federal budget deficits and debts exist, and major income tax overhauls are being discussed), would strip life insurance products sold in the future of many of the tax preferences the insurance companies have so long enjoyed.

Tax Disadvantages. While annuities generally offer the prospect of income tax deferral, there are also multiple tax disadvantages of annuities, generally, including FIAs. First, unlike contributions to qualified retirement accounts and IRAs, the contract owner pays premiums on non-qualified FIAs with after-tax dollars. Second, when withdrawn, earnings inside the FIA are taxed as ordinary income tax; lower capital gains tax rates won't apply. Third, no stepped-up basis occurs upon the owner's lifetime, thereby shifting the income tax burden to heirs (who often pay taxes at higher combined federal/state/local income tax rates). In this regard, if a trust is named as beneficiary and the trust does not terminate in the year in which annuity payments are received, taxation at the highest marginal tax rates often occurs. Fourth, withdrawals made prior to age 59½ are generally subject to a 10 percent penalty tax.

Often this author has seen FIAs owned by individuals who, due to low amounts of social security and pension income, possess no income tax liabilities in retirement, or who are in very low marginal tax

¹³ "Life After Death: Moody's Examines Life Insurance Insolvency" (1999), available at <http://v2.moody.com/cust/content/content.ashx?source=StaticContent/Free+pages/Credit+Policy+Research/documents/archived/2002000000428667.pdf>.

brackets. In such instance, income tax deferral had little or no benefit to the client, and potentially a large negative impact in the future.

In this author's view, an investment advisor to an individual client cannot disclaim the duty to ensure that income taxes are minimized, given the investment strategy utilized, investment products selected, and other aspects of investment portfolio design (such as the allocation of investments appropriately as between taxable and tax-deferred accounts). It's not what the client makes ... it is what the client keeps, that matters.

Consider Alternatives to FIAs.

In all of my research to date, I have yet to come across a fixed indexed annuity which I would recommend to a client. The high fees and costs of FIAs, as well as insurance company financial strength concerns, have ruled out all of the products our firm has surveyed.

Moreover, the investment strategy utilized within the product could be replicated outside of a fixed annuity product (such as through a combination of fixed indexed investments and call options), although a high degree of skill in the employment of options and in fixed indexed investing would be required of the investment adviser to pursue such alternative strategies on behalf of a client.

Suggested FIA Disclosures.

If the sale of an annuity is undertaken by an investment adviser (registered or unregistered) subject to the anti-fraud provisions of the Investment Advisors Act of 1940, or if the "financial advisor" (insurance agent or registered representative) is a fiduciary as a result of the establishment of a relationship of trust and confidence with the client, broad fiduciary duties of due care, loyalty, and utmost good faith apply to which the advisor's conduct must conform.

The fiduciary standard of conduct is the highest standard of conduct found under the law. Generally, the "fiduciary duty is the duty of an agent to treat his principal with the utmost candor, rectitude, care, loyalty, and good faith – in fact to treat the principal as well as the agent would treat himself."¹⁴ Moreover, a "fiduciary's independent investigation of the merits of a particular investment is at the heart of the prudent person standard."¹⁵

Despite their many limitations and high fees and costs, fixed indexed annuities are marketed heavily, in part due to the allure to clients of participating in stock-market returns while "never" suffering losses. The weak suitability standard largely protects insurance agents and registered representatives when

¹⁴ *Fink v. Nat'l Sav. & Trust Co.*, 772 F.2d 951, 957 (D.C.Cir.1985) (applying ERISA).

¹⁵ See *Jensen v. Snellings*, 841 F.2d 600 (C.A.5 (La.), 1988).

they engage in the sale of such products; there are not imposed upon non-fiduciaries the broad fiduciary duties involving diligence and loyalty.

Yet, when a fiduciary engages in the sale of FIAs, much more is required than just presenting standard sales literature, gathering basic information regarding a client's situation, and ensuring contract forms are signed. As noted above, a registered (or unregistered) investment adviser has a duty to conduct a reasonable and diligent inquiry into each and every investment product recommended, and he or she is charged with the knowledge of all the facts such an investigation would have disclosed.¹⁶ Indeed, a fiduciary who abstains from adequate inquiry, where inquiry ought to have been made to uncover material facts regarding an investment product, cannot be heard to say so and to rely on his or her ignorance. In essence, the material facts regarding the costs, fees, tax implications, and risk characteristics of a fixed indexed annuity, whether actually uncovered – or whether they should have been discerned – must be disclosed to the fiduciary's client.

It should be noted that while fee-only compensation removes many conflicts of interest, commission-based compensation is not outlawed in a fiduciary-client relationship. A "fiduciary may not have interests adverse to those of the client, and where a conflict of interest exists, nothing less than full and complete disclosure is required of the fiduciary ... If dual interests are to be served, the disclosure, to be effective, must lay bare the truth, without ambiguity or reservation, in all its stark significance."¹⁷ It is the RIA "firm's responsibility—not the customers'—to reasonably ensure that any material conflicts of interest are fully, fairly and clearly disclosed so that investors may fully understand them."¹⁸ This author

¹⁶ *Peterson v. H & R Block Tax Services, Inc.*, 971 F.Supp. 1204 (N.D. Ill., 1997).

¹⁷ *Williams v. Sidley Austin Brown & Wood, L.L.P.*, 2006 NY Slip Op 50381(U) (NY 3/13/2006).

¹⁸ SEC Release IA-3060 notes, with respect to the new Form ADV, Part 2A: "Item 5 requires that an adviser describe in its brochure how it is compensated for its advisory services ... [and] also requires each adviser to describe the types of other costs, such as brokerage, custody fees and fund expenses that clients may pay in connection with the advisory services provided to them by the adviser ... Item 5 also requires an adviser that receives compensation attributable to the sale of a security or other investment product (e.g., brokerage commissions), or whose personnel receive such compensation, to disclose this practice and the conflict of interest it creates, and to describe how the adviser addresses this conflict. Such an adviser also must disclose that the client may purchase the same security or investment product from a broker that is not affiliated with the adviser." [Rel. IA-3060, pp.15-16.]

Additionally, "Item 8 requires that advisers describe their methods of analysis and investment strategies and disclose that investing in securities involves risk of loss which clients should be prepared to bear ... this item requires that advisers explain the material risks involved for each significant investment strategy or method of analysis they use and particular type of security they recommend, with more detail if those risks are unusual ... advisers should disclose material risks associated with their strategies that will be relevant to most clients, regardless of whether they use one strategy or many strategies. We have, therefore, modified the item to require that advisers explain the material risks involved for each significant investment strategy or method of analysis they use, rather than those they primarily use, as we believe this threshold for disclosure better captures those methods of analysis or strategies that will be relevant to most clients." [Rel. IA-3060, pp.20-21.]

The SEC also notes in Release IA-3060: "Items in Part 2 of Form ADV may not address all conflicts an adviser may have, and may not identify all material disclosure that an adviser may be required to provide clients. As a result,

submits that the best means of resolving conflicts of interest involving commission-based compensation is to agree with the client, in advance, what the amount of the total compensation will be, and then seek out the best investment products.¹⁹ Variable compensation methodologies which result in the fiduciary advisor receiving more compensation for the sale of a particular product present a severe conflict of interest; in such circumstances the judgment of the fiduciary advisor in selecting a product which pays the higher compensation is highly likely to be later questioned (and the fiduciary's judgment subjected to intense scrutiny under an objective standard of review).

One must wonder if a fiduciary advisor could ever recommend an FIA to a senior citizen, especially when a recent Kiplinger article, reproduced on the AARP web site, reads: "An Annuity You Really Should Avoid: Big promises but skimpy returns plague equity-indexed annuities."²⁰

However, if your own due diligence efforts leads you to recommend a fixed indexed annuity product to your clients, I suggest a multitude of disclosures occur, in writing, at the time of undertaking such a recommendation. (Most of these disclosures may also be required in the RIA's Form ADV, Part 2A, if sales of FIAs are a "significant" investment strategy utilized by the RIA.)²¹

These recommended disclosures should be seen as a starting point for explaining to a client the potential negative characteristics of fixed indexed annuities; additional disclosures will always be required relative to specific products and insurance companies.

delivering a brochure prepared under Form ADV's requirements may not fully satisfy an adviser's disclosure obligations under the Advisers Act." (Rel. IA-3060, fn. 7).

¹⁹ There are multiple places to compare and contrast FIAs. One such web site is <http://www.annuityadvantage.com/annuitydataequity.htm>. Insurance and annuity wholesalers can typically provide insurance agents with specimen contracts and sales literature for further due diligence efforts. Insurance company financial strength ratings can be found through the rating agencies, although www.theinsuranceforum.com provides a monthly publication (including an annual ratings issue) which "shows 1,755 ratings assigned to 1,018 U.S. and Canadian life-health insurance companies and 657 ratings assigned to 272 large U.S. property-liability companies by A. M. Best Company, Fitch Ratings, Moody's Investors Service, and Standard & Poor's as of August 2, 2010. The issue includes a list of 138 life-health companies that are suggested for consumers who are conservative from the standpoint of financial strength"

²⁰ Kimberly Lankford, "An Annuity You Really Should Avoid: Big promises but skimpy returns plague equity-indexed annuities" (Kiplingers.com, reproduced on AARP web site) (August 31, 2010), available at http://www.aarp.org/work/retirement-planning/info-09-2010/kip_an_annuity_you_really_should_avoid.html.

²¹ "Study on Investment Advisers and Broker-Dealers," by the Staff of the U.S. Securities and Exchange Commission (January 2011), at p. 117. In footnote 532 of the SEC Staff's Report, the SEC staff noted: "Cf. letter from Ron A. Rhoades dated Dec. 20, 2010 ('The burden is upon the investment adviser to reasonably ensure client understanding') ...; Financial Planning Coalition Letter ... ('It is not sufficient for a firm or an investment professional to make full disclosure of potential conflicts of interest with respect to such products [e.g., collateralized debt obligations and structured products]. The firm and the investment professional must make a reasonable judgment that the client is fully able to understand and evaluate the product and the potential conflicts of interest that it presents.')."

RECOMMENDED BASE DISCLOSURE FORM:

- (1) The amount of the compensation [name of advisor's firm] will receive upon and following the sale of this annuity is [state amount or percentage]. The total compensation [name of individual advisor] will receive upon and following the sale of this annuity is [state amount or percentage]. [Also state if any sales awards, contests, or promotions are in place. Also state if other annuities with similar features are available which would pay the investment adviser less, and state the basis for the adviser's non-recommendation of such annuity. State whether no-load annuities are available. State whether annuities (whether FIAs or other fixed annuities) can be purchased directly by consumers without the utilization of the investment adviser and without payment of any commission.]
- (2) This fixed indexed annuity imposes a penalty, similar to a surrender charge, for early withdrawals from the annuity. The surrender fee schedule is equivalent to the following: [set forth schedule]. If you require funds from this fixed indexed annuity prior to (date) in excess of any (free withdrawal amounts each year, as described), you will incur surrender charges and ("will" or "may" as appropriate) suffer losses on your investment. You will possess limited rights to withdraw funds from the annuity product, and any withdrawals in excess of the amounts permitted under the annuity contract will incur a substantial surrender fee until such time as surrender fees disappear. You should purchase this annuity only with funds which you are not likely to require for your current or future expenses or other cash flow needs during the surrender fee period.
- (3) The credit given to you during any period for index returns during each period:
 - does not include dividends which would have been received by an index fund tied to that index and which would otherwise have been reinvested in that index. While the dividend rate for the S&P 500 Index (include rates of other indices, if recommended to be utilized) is ___% as of (date), historically the dividend rate has been approximately 3.6% (over the last six decades) and at times has exceeded 6%. If in the future dividend payout rates are higher due to changes in U.S. federal income tax policy, or due to other factors (such as shareholder demand for payment of dividends, versus retention thereof), the index returns you are eligible to participate in (subject to participation rates, caps, and deductions for administrative charges, discussed below) could be further significantly impaired.
 - is further limited by a cap on the index returns. This cap limit the amount of interest credited to your annuity contract, and is described as follows [insert description]. The insurance company reserves the right to lower such caps, which would negatively affect your returns. In the past (this insurance company / other insurance companies) has/have lowered caps on index returns.
 - Is further limited by the participation rate which [describe with particularity] ... The insurance company reserves the right to lower the participation rate, which would negatively affect your

returns. In the past (this insurance company / other insurance companies) has/have lowered the participation rate with respect to the index returns.

- is further limited by market value adjustments which [describe with particularity] ...
- is further limited by the imposition (annually) of “administrative charges” which [describe with particularity]. The insurance company reserves the right to increase the administrative charges, which would negatively affect your returns. In the past (this insurance company / other insurance companies) has/have increased administrative charges.

- (4) The funds placed with the insurance company are part of the insurer’s general account and subject to the general claims of the insurance company’s creditors; unlike a mutual fund or variable annuity sub-account your annuity funds are not segregated and therefore your funds are NOT protected in the event of insolvency of the insurance company. The ability of this insurance company to make payments to you, throughout the term of this annuity contract and upon your termination of this annuity contract, is dependent upon the financial strength of the insurance company. This investment is not insured against loss of principal due to default by the insurance company by any federal or state government agency. [Name of life insurance company] is rated [rating] by A.M. Best, [rating] by Fitch, [rating] by Moody’s, and [rating] by [other rating services]. These ratings are explained in the chart set forth on the next page. [Set forth chart on another page, describing each rating.] Insurance companies which possessed a rating higher than the ratings assigned to [name of insurance company] have become insolvent within twenty years following the assignment of such a rating; hence, a high financial strength rating is no guarantee that an insurance company will not default in the future of its obligations under this annuity contract. Various tax proposals exist which, if they were to be enacted, could adversely affect the commercial viability of many life insurance and annuity products, which in turn could significantly impair the ability of many insurance companies to meet their obligations to their present insurance policy holders and annuity contract owners.
- (5) Any withdrawals from the annuity of gains within the annuity will be taxed at your ordinary income tax rates. Gains are distributed prior to the return of principal. You will not receive more favorable long-term capital gain treatment which would have been available through a tax-efficient or tax-managed stock mutual fund, and as a result you will likely pay higher income taxes on any gains inside this FIA (in comparison to tax efficient stock funds).
- (6) If you, the annuity owner, are under the age of 59½, withdrawals from the annuity before you reach age 59½, like early withdrawals from other tax-deferred annuity products, would likely be subject to a 10% federal penalty tax, in addition to other income tax which may be owed.
- (7) Unlike mutual funds held in taxable accounts, annuities do not receive any stepped-up basis upon the death of the fixed indexed annuity owner. (Such a stepped-up basis eliminates unrealized capital gains upon the death of the mutual fund owner, which would likely offer significant tax

reduction to individuals and private trusts which inherit a stock mutual fund.) Additionally, beneficiaries of this annuity will be taxed on the annuity's gains at their ordinary income tax rates, which (combined federal, state and local) marginal income tax rates may be higher or lower than your own combined ordinary income tax rate, depending upon the situation.

- (8) If you are replacing this existing annuity or life insurance policy with this fixed indexed annuity contract, the death benefit promised under the prior annuity or insurance policy (including any guarantee that my beneficiary will receive more than the annuity's current market value) will not transfer to this new annuity. Furthermore, you will incur new sales charges. Additionally, a new surrender fee period will be imposed. All of this results without necessarily receiving any major benefit as a result of the replacement.

Again, the foregoing disclosures, required of a fiduciary advisor, are merely a starting point. Fixed indexed annuities are complicated products. Not only should the RIA thoroughly understand how each FIA contract recommended function, but the RIA should ensure that the client reasonably understands each and every feature and characteristic of the FIA prior to the client purchasing same. Moreover, investment product due diligence will require a review of the universe of FIAs available for recommendation by the investment adviser, in order to recommend to the client those few FIA products, if any, which are in the client's best interests.

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