

# Michigan's Annuity Suitability Requirements

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By Shane B. Hansen and Kate Hickner-Cruz

Effective September 29, 2006, Michigan joined a growing number of states seeking to protect consumers from the inappropriate sale of annuities by adopting annuity suitability standards and related requirements. Michigan's annuity suitability requirements are a response to the growing concern among state and federal regulators, as well as self-regulatory organizations, about the predatory sale of annuities, especially variable annuities. A new Chapter 41A, *Annuity Recommendation to Consumers*, was added to the Michigan Insurance Code.<sup>1</sup> The amendments were based on the National Association of Insurance Commissioners' (NAIC) Senior Protection in Annuity Transactions Model Regulation.<sup>2</sup> Michigan regulates all types of annuities exclusively as insurance products and not as securities. Under federal securities law, variable annuities are regulated as securities.

Michigan's annuity suitability requirements establish the statutory basis for Michigan's Office of Financial and Insurance Services (OFIS) to inspect and respond to consumer complaints about the suitability of both fixed and variable annuity sales. No private cause of action was created by these Insurance Code amendments, so consumers' recourse with respect to an unsuitable annuity sale is to seek assistance from OFIS by filing a complaint.<sup>3</sup>

Michigan's annuity suitability requirements have a broad scope, but there are some important exclusions from their application. The requirements apply with respect to any annuity that is individually solicited and recommended by an insurance producer (or an insurer where no producer is involved).<sup>4</sup> Individual and group annuities are covered, including both fixed and variable contracts. While originally proposed to apply only to seniors, the final version of the law is not limited by age. The requirements do not apply to any "direct response solicitations" (an undefined term used in the statute) where no recommendation has been made to a consumer for an annuity transaction based on information collected from the consumer.<sup>5</sup>

Furthermore, the requirements do not apply to any recommendation involving annuities used to fund certain ERISA plans, employer plans, government or church plans, government or tax exempt organization deferred compensation plans, nonqualified deferred compensation arrangements, formal prepaid funeral contracts, or settlements or assumptions of liabilities associated with personal injury litigation or any dispute resolution process.<sup>6</sup> Finally, the requirements only apply to annuities and do not apply to other types of insurance products.

Because variable annuities are federally regulated as securities, those products can only be offered and sold through a registered broker-dealer that is a member of a self-regulatory organization, commonly the National Association of Securities Dealers, Inc. (NASD). Fixed annuities are not federally regulated. NASD Rule 2310, *Recommendations to Customers (Suitability)*, has long imposed a suitability standard and related requirements with respect to the recommendation of all types of securities. Insurers and insurance producers that comply with NASD Rule 2310 are deemed to satisfy Michigan's annuity suitability requirements with respect to those products. Michigan's annuity suitability requirements are similar to NASD Rule 2310's requirements; however, those NASD requirements do not apply to fixed insurance products. Michigan's requirements apply regardless of whether the annuity is fixed or variable. For this reason, Michigan's requirements will have the greatest impact on the recommendation and sale of fixed annuities that are regulated by the Michigan Insurance Code and were not previously subject to any suitability requirement.

The Michigan annuity suitability amendments to the Insurance Code impose four mandates. First, before making a recommendation, insurance producers and insurers are required to seek financial information from the consumer (the consumer is not required to provide it). An insurance producer (or an insurer when an insurance producer is not involved) must make reasonable ef-

forts to obtain the consumer's financial status, tax status, investment objectives, and all other information used or considered to be reasonable by the insurance producer or the insurer.<sup>7</sup> This is substantially similar to the requirements of NASD Rule 2310(b).

Second, the Michigan annuity suitability requirements mandate an analysis of the consumer's financial facts and circumstances. An insurance producer (or an insurer if there is no insurance producer involved) must have reasonable grounds for believing that the recommendation for the purchase or exchange of the annuity is suitable for the consumer based on all the facts the consumer discloses regarding the consumer's investments, other insurance products, financial situation, and financial needs.<sup>8</sup> Stated differently, the law requires that the recommendation must be reasonable under all the circumstances known to the insurance producer (or the insurer) at the time of the recommendation. Insurance producers and insurers are not required to have reasonable grounds for believing the annuity recommendation is suitable for a consumer if the consumer refuses to provide relevant information that the insurer or the insurance producer requests, decides to enter into an insurance transaction that is not based on the insurer's or insurance producer's recommendation, or fails to provide complete or accurate information.

Third, insurers and insurance producers are required to adopt a system of supervision reasonably designed to ensure compliance with these annuity suitability requirements.<sup>9</sup> An insurer can fulfill this requirement by either itself establishing and maintaining a supervision system to ensure compliance with the suitability standards or assuring the establishment and maintenance of such a system by contracting with a third party to do so. The third party can be an insurance producer.<sup>10</sup> Regardless, the supervision system must include maintaining written procedures and conducting periodic record reviews that are reasonably designed to assist in detecting and preventing violations of the suitability requirements. Even if an insurer contracts with a third party to establish and maintain the supervision system, the insurer still must make a reasonable inquiry to assure that the third-party contractor is establishing and maintaining the supervision system in accordance with the law and, when necessary, enforce the contractual obligations of the third party. Insurers will comply with their obliga-

tion of reasonable inquiry if they do both of the following:

- Annually obtain a certification from the third party's senior manager, who has responsibility for the delegated functions and who has a reasonable basis for making the certification that the third party is performing the required functions; and
- Periodically selecting the contracting third parties based on reasonable selection criteria and reasonably reviewing the criteria to determine whether the third parties are performing the required functions.<sup>11</sup>

An insurance producer must either adopt the insurer's supervision system that is established to achieve compliance with Michigan's suitability requirements or must establish and maintain its own system to ensure compliance with the law.<sup>12</sup> The insurance producer's supervision system must include maintaining written procedures and conducting periodic record reviews that are reasonably designed to assist in detecting and preventing violations of the suitability requirements.<sup>13</sup>

Fourth, these Insurance Code amendments impose related recordkeeping requirements. Michigan's requirements are simpler than the analogous requirements of NASD Rule 3110, *Books and Records*, and the federal securities laws and related rules that Rule 3110 incorporates.<sup>14</sup> Under Michigan law, insurers and insurance producers need to maintain or be able to produce records of the information collected from the consumer and other information used in making the annuity recommendations for five years after the completion of the resulting insurance transactions. Insurers are permitted, but not required, to maintain documentation on behalf of insurance producers. Insurers and insurance producers can maintain the required records electronically, in paper, or through a variety of other forms.<sup>15</sup>

While Michigan's annuity suitability requirements and NASD Rule 3010, *Supervision*, both require supervisory systems tailored to the operations of insurers, insurance producers, or NASD members, as applicable, Michigan's requirements are substantially less detailed than NASD Rule 3010, providing little guidance in creating such a supervisory system. Insurers (and insurance producers) that are not members of the NASD, and hence are not subject to NASD rules, may find the NASD's rule useful in designing their own system applicable to fixed annuity products.<sup>16</sup>

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## NOTES

1. 2006 PA 399 (codified at MCL 500.4151-4165 as part of the Michigan Insurance Code of 1956).
2. More information about the National Association of Insurance Commissioners can be found at: <http://www.naic.org>.
3. OFIS can be contacted by calling (517) 373-0220 or (877) 999-6442. More OFIS information can be found at: <http://www.michigan.gov/cis/0,1607,7-154-10555-40266--,00.html>.
4. MCL 500.4153(1).
5. MCL 500.4153(2)(a).
6. MCL 500.4153(2)(b).
7. MCL 500.4155(2).
8. MCL 500.4155(1).
9. MCL 500.4157(1).
10. MCL 500.4157(2)-(3).
11. MCL 500.4157(4).
12. MCL 500.4157(2).
13. *Id.*
14. See Rules 17a-3 and 17a-4 promulgated by the Securities and Exchange Commission pursuant to the Securities and Exchange Act of 1934, as amended.
15. MCL 500.4163.
16. Examples of significant sources of SEC/NASD guidance include Joint SEC/NASD Report On Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products, June 2004; NASD Notice to Members 96-86 (NASD Regulation Reminds Members and Associated Persons that Sale of Variable Annuities are Subject to NASD Suitability Requirements), NASD Notice to Members 99-35 (the NASD Reminds Members of Their Responsibilities Regarding the Sales of Variable Annuities), NASD Notice to Members 01-23 (Suitability Rule and Online Communications). These materials can be found on the NASD Web site at <http://www.nasd.com/RulesRegulation/NoticestoMembers/2007NoticestoMembers/index.htm>.



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