

## Annuities Industry Ducks New Rule. What Now?

The **Security and Exchange Commission's** attempt to regulate indexed annuities suffered a setback from an appeals court Monday. The U.S. Court of Appeals for the District of Columbia Circuit said the SEC's process for assessing the benefits and disadvantages of the proposed regulatory changes was flawed and vacated the agency's rule 151-A, which had classified indexed annuities as securities. Now, industry watchers say investors face the continued threat of bad practices by companies selling those products, leaving their retirement savings vulnerable.

Indexed annuities, whose payout is partly tied to an index of stocks or bonds, straddle the line between insurance and securities products. The SEC has been pressing to treat them as securities, arguing that they carry investment risk. The insurance industry has opposed this treatment, saying that the annuities include a guaranteed minimum return that makes them less risky than other investments and that the benefits of the proposed changes aren't clear.

The products can make help diversify a retirement portfolio and include floors, or limits that ensure that the purchaser will never lose money on the investment. Some offer a minimum return. However, they also have a ceiling that can cap potential gains, and hefty fees, especially if for investors who want to pull out.

Efforts to regulate the industry had already been dealt a setback in December, when the SEC agreed to a two-year stay on its rule bringing indexed annuities under its jurisdiction. In February, Old Mutual, an annuities dealer, pushed for the rule to be abandoned altogether. (Monday's ruling granted that request.)

For Old Mutual and the industry, the stakes of the decision were high. For instance, the rule would have required those selling indexed annuities to become licensed brokers. The SEC estimates that implementing the new regulation would add 240,000 hours -- 60,000 to the issuers themselves and 180,000 to outside professionals -- for a total cost of \$72 million for the professionals, calculated at \$400 an hour.

For investors, the upshot of the court ruling is less clear.

Eric Marhoun, general counsel of Old Mutual, says that the court's decision (and the anticipated passage of Financial Regulatory Reform by Congress clarifying the exemption for annuity products from the Securities Act), benefits consumers by helping ensure that "unnecessary and duplicative" regulations aren't imposed because the cost ultimately falls mostly on the shoulders of consumers.

Critics of existing efforts to protect consumers argue investors and many people selling the products don't completely understand them and that their state-by-state regulation breeds confusion.

"I think investors need to read a prospectus and understand what they're getting into," says Charles Rotblut, vice president of the America Association of Individual Investors. "The whole pitch is that there's a minimum rate of return, but the danger is if they buy it thinking they'll have all the upside -- they are giving up upside return for downside protection."

Other advocates of national regulation say past failures illustrate the need for tighter controls. "Certainly the insurance industry has a bad history of putting people into inappropriate products -- a worse history than Wall Street in terms of brokers," says Keith Amburgey, an advisor with Rutherford Asset Planning. He adds that another problem of insurance regulation is that it's a patchwork of different states' regulations, an issue made evident with the fallout **American International Group (AIG 1)** in 2008, when "there wasn't a national insurance regulator they could answer to."

State regulators agree to common rules through the National Association of Insurance Commissioners. The NAIC on March 28 adopted revisions to its Suitability in Annuity Transactions Model Regulation to "better protect consumers from inappropriate and abusive marketing practices." The revisions clarify that the insurer is responsible for the model's requirements, even if the insurer contracts with a third party; require the review of all annuity transactions; and establish general and product-specific training requirements for producers, according to the NAIC. However, because the regulations are a model law, states are not required to comply.

Craig Hemke, founder and president of Buyapension.com, says the problem is not necessarily with the products, but with the sales practices. "You only have to have a state insurance license to go out and sell one of these things," he says. "You have people who are out there purporting to be planners or advisers with no other training than passing a life insurance licensing test."

So without a federal mandate to oversee disclosures about annuities, what should investors watch out for?

Hemke and Amburgey say the biggest misunderstanding about indexed annuities -- the one that repeatedly comes back to haunt investors -- is the so-called "surrender charge," or the fee levied in the first five to 10 years for pulling money out. The fee can be as high as 15% in the first five years. Because of the cap on returns, a fee of that magnitude is likely to negate any profit if investors need to withdraw money early for an emergency.

Hemke says the surrender fee is necessary for the products to offer their guarantees but that the business model is not communicated clearly. "It's not understood by the agent, because they don't understand how they work, or much worse, it's not disclosed because they don't understand or don't take seriously a fiduciary responsibility," he says.

Amburgey suggests investors stick with large, well-rated insurance companies and make a point to check surrender fees, ongoing fees and tax savings, and compare the product to a mutual fund. For instance, a fee difference of 1% a year could be a significant consideration, he says. Many investors are attracted to the products because they're more tax efficient, but the true value of the tax benefit isn't always clear.

Conservative investors drawn to the floor or loss-control might compare the products to the performance of a few other investments like mutual funds over long periods of time, Amburgey says.

<sup>1</sup><http://www.smartmoney.com/quote/AIG/>

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