## CALIFORNIA 4-HOUR ANNUITY TRAINING
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# I How Fixed, Variable, and Index Annuity Contract Provisions Affect Consumers

## A. Identifying and Discussing Contract Provisions

The provisions described here are all common but every one is not available in every contract. **Purchasers must read the contract!** The terms and conditions should be understood by the buyer before completion of the sale. The descriptions here are examples only. Features included in a contract will be defined in the contract. Thus the “owner,” “annuitant,” and “beneficiary” will all be spelled out in the contract definitions.

**Contract loans-** A loan provision may be included in an annuity contract. In general, this feature allows one to borrow up to a specified amount of the annuity’s accumulated value. Since it is a loan, interest will accumulate and it most likely will be to the owner’s advantage to repay it. Like the withdrawal privilege, a loan provision can give some liquid features to an annuity.

**Return of principal guarantee -** Surrender of the contract should be avoided whenever possible, but individual circumstances may leave a person with no other choice. If an annuity must be surrendered, this feature gives assurance that the company will pay no less than the total dollars that have been paid in premiums (minus any prior partial withdrawals). It applies even if the amount is greater than the cash surrender value defined by the contract.

**Minimum Initial Premium-** Each annuity contract will designate a minimum premium that the policyowner must pay to purchase an annuity. Normally these amounts are in the $5,000–$10,000 range for single-premium policies and $25–$50 per month for flexible-premium policies. Insurance companies may designate a different minimum amount, depending on the type of funds the client places inside the annuity. For example, a policy might show a minimum premium of $1,000 for a qualified single-premium annuity but still keep the nonqualified annuity minimum premium at $5,000. Lower premium amounts are common for qualified contracts so that the annuity can accept small annual IRA contributions.

**Issue Age** Each annuity contract will have a provision for the minimum and maximum age of the owner or the annuitant who can purchase the contract. Generally, the insurance company is more interested in the age of the annuitant for purposes of mortality. But the issue age of the owner is also important because of legal issues related to minors who purchase the contract. Normally, an insurance company does not want a minor to own one of its policies because of the minor’s legal right, upon reaching the age of 18, to rescind a purchase made while he or she was a minor. For our purposes, we will consider the issue age of the annuitant. Usually, annuity contracts allow annuitants between the ages of 18 and 85. Some companies may stop issuing annuities at age 70 or 75; other companies will issue annuities up to age 90. In addition, the insurance company may limit the issue age based on the type of funds in the annuity. Qualified annuity contracts typically carry a maximum issue age of 70, while nonqualified annuities will be issued to age 85 or 90. The reason for the qualified funds’ limitation is based on the minimum distribution requirements for qualified annuity contracts. The tax code stipulates that qualified plans distribute a certain percentage of the account after the owner reaches age 70 1/2.

**Options Involving the Spouse-** The spouse as the beneficiary of an annuity contract may choose not to accept the death benefit and instead may choose to continue the annuity contract with the insurance company. The insurance company will change the owner from the deceased person's name to that of the spouse.

**Settlement Options-** Deferred annuity contracts also include provisions for taking the money out of the contract at some future contract-owner-determined date- called annuitization- or at some other agreed-upon date. These optional modes of settlement may be taking a lump-sum withdrawal, leaving the proceeds in the contract at interest, choosing fixed-period or fixed-amount payments, or selecting the various life contingent or joint-life-contingent options. Little attention is given to these contractual provisions in periods of high interest rates. As interest rates fall and longevity has increased, the guaranteed lifetime annuitization factors and interest rate guarantees of 3% have real value in comparison to the guarantees in new annuity contracts. The minimum payout rates for settlement options are listed in the annuity policy. In a normal economy, these rates are much lower than what the annuity company can afford to pay. Therefore, it is important for the owner to look at the guaranteed settlement option rates in the policy and compare those rates to the current offerings from the insurance company to be sure to obtain the best rates available. Surrender of the contract should be avoided whenever possible, but circumstances may leave the policyholder with no choice. If someone must surrender his or her annuity, this feature gives assurance that the company will pay no less than the total dollars that have been paid in premiums — minus any prior partial withdrawals already taken. It applies even if the amount is greater than the cash surrender value defined by the contract.

**Death Benefits-** If the entire annuity value is not consumed during retirement, when the annuitant dies, the annuity will still be in force. Annuities contracts have provide for a beneficiary or some other party to legally receive the values at the annuitant's death. The death benefit can be classified in one of two ways depending on how the death benefit is payable in the policy: Policies are either annuitant driven or owner driven. See Section I B for further discussion.

## 1. Interest Rates and Compensation

A real interest rate is the compensation, over and above inflation, that a lender demands to lend his money. Earning $100 today is preferable to earning $100 a year from now. If a person earns $100 today, it can be spent or invested now. The use of $100 earned a year from now must be deferred until that time. This is an example of the time value of money, a fundamental principle of budgeting and investing. The economy determines a general time value of money through the level of interest rates.

**a. First Year Bonus 'Teaser' Rates**

This is additional interest granted to new purchasers of annuities that is paid on top of the normal stated current interest rate. These amounts are usually based on the total dollars contained in the contract during its first year. These annuities are often used to attract money from existing annuity contracts, which still may be subject to a surrender charge, by paying extra interest in the first year. This extra interest (the bonus) is designed to offset some of the loss caused by the termination of the old policy. A Bonus rates is an incentive to get people to purchase an annuity. Big bonus incentives mean bigger constraints on when that bonus will be applied or earned. Any forfeiture and possibly even a withdrawal prior to the end of the surrender charge period could void the bonus. Interest rate bonuses often encourage replacement of annuities. The policyowner is lured by the high interest rate and a bonus above the normal current interest rate; the annuity owner may feel that the bonus will help to offset any surrender penalties. Bonus annuities can bear much higher surrender charges than those annuities found without the feature.

## 2. Issue Ages

The insurance contract has the basic elements of any other contract. Those elements are summarized (not in correct order) by the acronym COALL. It stands for Consideration, Offer, Acceptance, Legal capacity to contract, and Legality of subject matter. Notice should be given to the fact that <u>in writing</u> is not an element that must be present to have a valid contract. This is important where the concepts of waiver and estoppel are concerned, but beyond our current scope. Generally speaking, a person has the legal capacity to contract when he or she reaches the age of majority, 18 years. In common law, persons under 18 can contract, but the contract is voidable at his or her discretion.

At the upper-end of the age spectrum contracts allow annuitants up to age 85. Some companies may stop issuing annuities at age 70 or 75; other companies will issue annuities up to age 90. In addition, the insurance company may limit the issue age based on the type of funds in the annuity. Qualified annuity contracts typically carry a maximum issue age of 70, while nonqualified annuities will be issued to age 85 or 90. The reason for the qualified funds' limitation is based on the minimum distribution requirements for qualified annuity contracts. The tax code stipulates that qualified plans distribute a certain percentage of the account after the owner reaches age 70 1/2.

With respect to insurance and annuity contracts, the common law provisions have been modified by statute. An insurance or annuity contract may be issued to or indicate the named insured as a person under the age of 18 for the benefit of the minor or for the benefit of the parents, spouse, child, or siblings of the minor. Likewise, a contract can be issued to a minor, subject to written consent of a parent or guardian, upon the life of any person in whom the minor has an insurable interest for the minor's benefit or such minor's parents, spouse, or siblings. Subject to approval of a parent or guardian, a minor may give a valid discharge for any benefit accruing or for any money payable. Contractual matters involving minors under the age of 16, as determined by the nearest birthday (meaning 15½), need the written consent of a parent or guardian. These minimum age limitations are subject to the terms of the California Probate Code, which gives mechanisms for a guardian or conservator to act in *loco parentis,* in the place of the parents. That is, in the best interest of the ward or conservatee. (Section 10112)

## 3. Maximum Ages for Benefits to Begin

**Non-Qualified Annuities-** Annuities are based on life expectancy. Being non-qualified, the tax code specifies no maximum age limitation for contributions or withdrawals. It is at the issuer's discretion as to age at which payments must begin. Once annuitization occurs, payments must be spread evenly over the life expectancy of the annuitant.

**Qualified Plans-** To make sure that most of the retirement benefits are paid to the plan participant during his or her lifetime, rather than to subsequent beneficiaries after an individual's death, the payments that are received from qualified retirement plans must begin no later than the plan participant's ***required beginning date*** (defined later). The payments each year cannot be less than the ***minimum required distribution***.

If the actual distributions to an individual in any year are less than the minimum required distribution for that year, he or she is subject to an additional tax. The tax equals 50% of the part of the required minimum distribution that was not distributed. A qualified retirement plan includes a qualified employee annuity plan and a tax-sheltered annuity plan (403(b) plan) (for benefits accruing after 1986).

**Required beginning date-** Unless the rule for 5% owners and IRAs applies, the plan participant must begin to receive distributions from the qualified retirement plan by April 1 of the year that follows the ***later*** of:

- The calendar year in which the subject individual reaches age 70½, or
- The calendar year in which the person retires.

***5% owners-*** If a person is a 5% owner of the employer maintaining the qualified retirement plan, the plan participant must begin to receive distributions from the plan by April 1 of the year that follows the calendar year in which he or she reaches age 70½. This rule does not apply if the retirement plan is a government or church plan.

A person is a 5% owner if, for the plan year ending in the calendar year in which he or she reaches age 70½, the person in question owns (or is considered to own under section 318 of the Internal Revenue Code) more than 5% of the outstanding stock (or more than 5% of the total voting power of all stock) of the employer, or more than 5% of the capital or profits interest in the employer.

***Age 70½-*** A person reaches age 70½ on the date that is 6 calendar months after the date of their 70th birthday. For example, if your 70th birthday was on June 30, 2004, you reached age 70½ on December 30, 2004. If your 70th birthday was on July 1, 2004, you reached age 70½ on January 1, 2005.

**Required distributions-** By the required beginning date, as explained above, the plan participant must either:

1) Receive his or her entire interest in the plan (for a tax-sheltered annuity, the entire benefit accruing after 1986), or

2) Begin receiving periodic distributions in annual amounts calculated to distribute the entire interest (for a tax-sheltered annuity, the individual's entire benefit accruing after 1986) over a person's life or life expectancy or over the joint lives or joint life expectancies of the plan participant and his or her designated beneficiary (or over a shorter period).

## 4. Crisis Waivers

With a waiver, access can be provided to an annuity before retirement. Some annuities contain a waiver that triggers payments not subject to the usual surrender fees. According to information published on the Web (as of July 2004), the Variable Annuity Research and Data Service (VARDS) reports that 161 variable annuity contracts offer some type of waiver. Also, Beacon Research, an annuity-tracking service based in Illinois, surveyed 282 fixed annuities and found that 35 % have a death waiver; 18.5 % contain nursing home waivers; 7.4 % have hospital waivers; and 2.3 % carry disability waivers.

While a death waiver is most common in the fixed annuities survey, VARDS shows the most popular waiver found in variable annuities is the nursing home waiver, with 103 variable annuity contracts containing that provision; 83 provide death waivers; 69 have terminal illness waivers; and 42 carry disability waivers. Situations that trigger the waiver and allow early annuity withdrawals vary from company to company.

**Nursing Home-** One insurer might require a 90-day nursing home confinement before benefits are activated, while another might call for 60 days. With a nursing home waiver, surrender fees will not be charged and access is granted to some or the entire annuity if an individual is put in a nursing facility. A 90-day confinement period before benefits begin may be typical, longer periods could apply. A doctor will normally be asked to then submit an attending physician's statement, along with a completed claim form.

**Disability-** With this type of waiver, one company may consider an individual disabled if he or she is unable to work in any occupation, while another may require only that a person is unable to work in their current vocation The risk of disability is greater than the risk of death at all ages between 20 and 65. It is prudent to protect oneself financially if disability does occur, and that includes annuity considerations.

**Terminal Illness-** The same can hold true if a policyholder becomes terminally ill, thus allowing access to money when it may be needed most. The definition of terminally ill may vary from company to company; it's generally a condition that will result in death within six months to a year.

**Unemployment-** This is another condition for which a waiver of surrender charges could be added.

Waivers are granted for specific conditions, and the contract waiver provisions may differ between policies and companies. Insurers may charge additional premium for a waiver. Liquidity is always an issue during a financial emergency. Purchasers of annuity contracts must be made aware that without a waiver additional charges and fees can apply when access to funds in the annuity contract is necessary.

## 5. Premium Payments

Incorporated life insurers that issue policies on the reserve basis can collect premiums in advance. Insurers are limited by statute as to the amount of advance premium that can be collected. However, the Insurance Code does not limit the ability of insurers to accept payment under an agreement that provides for an accumulation of such funds for the purpose of purchasing annuities at future dates. (Section 10540)

## 6. Settlement Options- Death of Owner or Annuitant

A settlement option offering payments after the death of the owner or annuitant offers a hedge against the loss of value of the annuity in the event of an early death. Various types of settlement options include;
**Life with period certain guarantee**- Payment is made for the longer of the annuitant's lifetime or a certain period of years. If the annuitant dies, payments continue to the beneficiary.
**Refund Life Annuity-** At the annuitant's death, if the accumulation amount applied to the annuitization of the contract is more than the total of payments made to the annuitant, the difference is paid to the beneficiary in a lump sum.
**Joint and Survivor Life Annuity-** This annuity pays out over the lifetime of two individuals. They must be natural persons. This type of annuity can be modified to allow a primary beneficiary to receive the full annuity payment while the secondary beneficiary would receive some fractional (half, two-thirds) payment.
**Fixed Amount Annuity-** The annuitant or beneficiary receives the annuity amount for a guaranteed certain number of periods. If the annuitant dies before the payments are exhausted, the beneficiary would continue to receive the balance of payments.

### a. Tax-Qualified Plan

Remember, with a tax-qualified plan, owner and annuitant are the same person. Any annuity payment that continues on with a beneficiary will be taxable. A death benefit may be purchased as a life insurance feature. The benefit was purchased with the policy and no tax is due. Otherwise payments to a beneficiary are payments of the tax-deferred accumulated value of the annuity and as such, tax is due.

### b. Non-Qualified Plan

If an individual receives a single-sum distribution from a variable annuity contract because of the death of the owner or annuitant, the distribution is generally taxable only to the extent that it is more than the unrecovered cost of the contract. If that person chooses to receive an annuity, he or she recovers the cost tax-free.

**c. Stretch Option**

The stretch annuity option is based on IRS Private Letter Ruling PLR 200151038.[1] This ruling allows the beneficiaries to continue the annuity, let it keep growing tax deferred over their lifetime as an option. The beneficiaries take distributions each year based on their life expectancy, which in turn allows the majority of the money to keep growing tax deferred and minimizes the taxes that are paid each year.

The private letter ruling goes on to state the following;

> The Companies have requested a ruling that where payments are made to a designated beneficiary under the procedures set forth in Requested Rulings 1, 2, and 3, no amount will be constructively received by the beneficiary prior to its actual payment under the specified payment procedure. An annuity contract consists of an accumulation phase and a phase subsequent to the ASD commonly referred to as annuitization. During the accumulation phase, all amounts received by the holder are “amounts not received as an annuity.” During the annuitization phase, if the requirements of Treas. Reg. § 1.72-2(b)(2) and (3) are met, amounts received by the holder may be characterized as “amounts received as an annuity.” During the annuitization phase, amounts received by the holder may, in certain circumstances, be characterized as “amounts not received as an annuity.” (See IRC § 72(e)(1)(A)(ii) and (e)(2)(A)). This ruling expresses no opinion on whether amounts paid to the designated beneficiary under the procedures set forth in Requested Rulings 1, 2, and 3, are “amounts received as an annuity” or “amounts not received as an annuity.” Nevertheless, under either conclusion, no amount will be constructively received by the beneficiary prior to its actual payment under the specified payment procedure.
>
> Section 72 of the IRC provides a comprehensive scheme for the taxation of life insurance, endowment, and annuity contracts. Section 72(a) and (b) provide, in general, for the taxation of “amounts received as an annuity.” Section 72(e), in general, taxes amounts received under life, endowment, and annuity contracts that are “not received as annuities.” Both § 72(a) and (e) literally require that amounts be “received” by the holder before they are included in gross income. …….

When this distribution method is exercised, the end result will be significantly more wealth will be passed to the beneficiary. It appears that the stretch option can be use by tax-qualified as well as non-tax-qualified annuities. However, not everyone or every

[1] A Private Letter Ruling (PLR) is “[a] written statement issued to the taxpayer by the Internal Revenue Service in which interpretations of the tax law are made and applied to a specific set of facts. [The] [f]unction of the letter ruling, usually sought by the taxpayer in advance of a contemplated transaction, is to advise the taxpayer regarding the tax treatment he can expect from the I.R.S. in the circumstances specified by the ruling.” *Black’s Law Dictionary*, p. 1196 (6th ed. 1990)(West Publishing Company)(citing *U.S. v. Wahlin*, D.C.Wis., 384 F.Supp. 43, 47.) “. . . [U]nless the Secretary establishes otherwise by regulations, a “written determination” may not be used or cited as precedent by another taxpayer. Sec. 6110(j)(3); sec. 301.6110-7(b), Proced. & Admin. Regs. Written determinations include both private rulings and technical advice memoranda . . . . Sec. 301.6110-2(a), Proced. & Admin. Regs.” *Lucky Stores, Inc. v. Commissioner*, T.C. Memo. 1997-70 (1997)

company can ‘stretch.’ A private letter ruling cannot be used or cited as precedent by another taxpayer. The annuity contracts must be set up properly and executed within a certain time frame to take advantage of stretching. An example is Sue Jones, a widow who passes away and leaves an annuity to her 54-year-old daughter, Jenny. If the distributions to Jenny are spread out over her remaining life expectancy of 30.5 years, this could prove to be a substantial amount.

## 7. Surrender Charges

Annuity contracts carry a surrender charge. A typical contract could have a surrender charge in effect over the first 10 years, but decreasing in amount each year. The contract will explain how the surrender charge applies. An annuity is a long-term investment. The surrender charge discourages the annuity owner from using the funds as a piggy bank. It also allows the insurer to cover the expense of selling and issuing the contract. The charge is usually a percentage of either the fund’s accumulated value or the total premiums paid. Surrender charges are generally waived under certain circumstances, such as death or disability of the annuitant.

Annuity contracts for senior citizens that contain a surrender charge period need to disclose the surrender period and all associated penalties in 12-point bold print on the cover sheet of the policy or disclose the location of the surrender information in bold 12-point print on the cover page of the policy, or printed on a sticker that is affixed to the cover page or to the policy jacket. The notice required by this section may appear on a cover sheet that also contains the disclosure required by subdivision (d) of California Insurance Code Section 10127.10, which be found in Section III E 1, “Free Look Period,” of this book. (Section 10127.13)
The word “values” as used in the following “Illustrations” section includes surrender value. (Section 10127.11)

### a. Illustrations

Any time nonpreprinted illustrations of nonguaranteed values are used in the course of a sales function, the insurer and selling agent must disclose on those illustrations or on an attached cover sheet, in a prominent manner the following statement:

"THIS IS AN ILLUSTRATION ONLY. AN ILLUSTRATION IS NOT INTENDED TO PREDICT ACTUAL PERFORMANCE. INTEREST RATES, DIVIDENDS, OR VALUES THAT ARE SET FORTH IN THE ILLUSTRATION ARE NOT GUARANTEED, EXCEPT FOR THOSE ITEMS CLEARLY LABELED AS GUARANTEED."

Preprinted policy illustrations must also contain this notice in 12-point bold print with at least one-half inch space on all four sides, printed on the illustration form itself or on an attached cover sheet, or in the form of a contrasting color sticker placed on the front of the illustration.

**b. Values**

All preprinted illustrations containing nonguaranteed values shall show the columns of guaranteed values in bold print. All other columns used in the illustration shall be in standard print. "Values" as used here includes cash value, surrender value, and death benefit. (Section 10127.11)

Whenever an insurer provides an annual statement to a senior citizen policyowner of an individual life insurance policy or an individual annuity contract issued after January 1, 1995, the insurer shall also provide the current accumulation value and the current cash surrender value. (Section 10127.12)

**a. Market Value Adjustment**

Market value adjustments are features added to some deferred annuities to discourage surrenders prior to their contractual maturity date. If, during the contract period and before the maturity date, money in excess of any free-corridor amount is withdrawn, it is subject to a market value adjustment. The market value adjustment is an increase or decrease in the annuity's value, depending on the level of the general economy's interest rates relative to the interest rates of the contract from which the withdrawal is taken. Annuities with market value adjustment features often offer a slightly higher interest rate than a comparable fixed annuity without such features. The market value adjustment works in the annuity contract in a manner similar to the way individual bond prices fluctuate. For example, if a contract owner has an annuity with a contractual interest rate of 8 percent with 5 years left prior to its maturity date, and similar contracts are being issued with 4 percent interest rates, the contract owner can expect some gain upon early surrender. This is because the surrender will relieve the insurance company from its 8 percent obligation in a market where interest rates have decreased to 4 percent. On the other hand, if the opposite occurred and the old contractual obligation was for 4 percent in a current interest rate market of 8 percent, the contract owner can expect a negative MVA and therefore will receive a smaller

## 8. Policy Administration Charges and Fees

Every insurer that sells annuities charges fees which are connected to the contract. These fees cover the company's costs of administering the annuity. Annuities may charge a nominal annual contract maintenance fee such as one percent of the cash value not to exceed $20–$50. These fees are usually deducted from the annuity cash values, and they will often expire when the contract accrues a certain amount of cash value such as $5,000 or $10,000. This contract provision less has become less common in newly issued annuity contracts.

## 9. Withdrawal Privilege Options

In the event the policyowner needs to access funds prior to maturity, the owner has the option of requesting a withdrawal, also called a partial surrender. Withdrawal provisions in deferred annuity contracts allow the policyowner limited withdrawal of funds prior to maturity of the contract. The surrender or withdrawal, if made during the surrender charge period, is normally subject to a surrender charge. If the withdrawal is requested after the policy is beyond its surrender charge period, the policyowner should be able to access the withdrawal without any charges imposed by the insurance company. Withdrawals are not expected to be repaid to the annuity contract. With flexible-premium policies, the withdrawal can later be paid into the annuity policy as new premiums. Annuity policies do not generally have loan provisions available to the policyowner due to tax consequences.

**Free-Corridor Amount-** To accommodate a contract owner’s unforeseen need for money, practically all companies provide a free withdrawal corridor. A free corridor is some maximum amount of money that a contract owner can withdraw from the contract each year without incurring a surrender charge. If a contract owner elects to make an early withdrawal of just part of the funds in an annuity contract before the end of the surrender charge period, there is likely to be a free-corridor amount that he or she can withdraw without any charge. Normally, this amount is about 10 percent of the last year’s accumulation value or 10 percent of the initial premium paid. However, some contracts do not allow any withdrawals without charge; the most generous allow withdrawals of up to 15 percent per contract year without charge. Amounts in excess of the free corridor amount are subject to proportional surrender charges. A prospective purchaser should carefully examine surrender charges and free-corridor provisions.

### 10. Annuitization Options

The annuitization phase starts with the first scheduled payment to the annuitant. The simplest form of annuity is the life annuity, where the annuitant receives scheduled payments for the remainder of his or her lifetime. The types of annuities settlement options are mentioned in IV A 6 above. Annuities can be immediate or deferred, variable or fixed. The opposite of any sort of annuitization would be some method of systematic withdrawal. The advantage of annuitization is its hedge against longevity. Systematic withdrawal has the advantage of immediate access to principal and the availability of better interest rates for the principal.

## B. Contract Provisions Typically Common to Fixed Annuities

Insurance companies develop and sell annuity contracts. The contract between the insurer and the client describes what happens during the accumulation and distribution phases of the contract. It sets forth the rights and obligations of the contracting parties. Generally speaking, the client agrees to be a purchaser and to place money into an annuity contract in order to have the rights offered under the contract. The insurance company agrees to the obligations because it has the capacity to meet those obligations and is in the business of doing so as a for-profit enterprise. Although insurance companies are regulated by the individual states and contract forms have to be acceptable to each state, in the interest of efficiency, there is a great deal of standardization in all annuity contracts.

## 1. Death Benefits

All deferred annuity contracts provide for a death benefit prior to the annuity starting date. Death payments after the annuity starting date would be a form of settlement option. Tax code changes in 1985 provide that a death benefit is payable if any owner of the annuity dies before the maturity date. See information further on in this section (a. & b. “Rights and Obligations….”) for further discussion. Some annuities provide that a death benefit is payable only if the owner dies, so long as the contract provides for a new annuitant to take the place of the deceased annuitant. The amount of the death benefit payable under a deferred fixed annuity will normally be the accumulated value of the contract, possibly reduced by any applicable surrender charge. Variable annuities also provide a death benefit, based on total premiums paid or the annuity’s account value.

Federal tax law calls for the distribution within five years of a contract’s entire cash value if the ‘holder’ (owner) dies before the maturity date. The entire death benefit must be distributed within five years of the date of the owner’s death. However, there is an exception to the five-year rule, if the death benefit is paid as an annuity over the life, or a period not longer than the life expectancy, of the beneficiary and the payments start within one year of the owner’s date of death. If an annuity contract has joint owners, the distributions at death rules are applied upon the first death. Under a special exception to the distribution at death rules, if the beneficiary is the surviving spouse of the owner, the annuity contract may be continued with the surviving spouse as the owner. If the owner of the annuity is a non-natural owner, then the annuitant’s death triggers the distribution at death rules. In addition, the distribution at death rules is also triggered by a change in the annuitant on an annuity contract owned by a non-natural person.

### a. Rights and Obligations of the Annuity Owner

The person who purchases the annuity is the owner. The Owner may be more than one individual, or an annuity can be held by a person that is not a natural person, such as a corporation or a trust (special rules apply for “nonnatural” Owners). The Owner may also be the Annuitant or the Beneficiary. There is no limit to the number of Owners on any one contract.

#### i. Entities Eligible for Annuity Ownership

The owner of an annuity is the party who pays the premiums for the contract. The owner of a nonqualified annuity is the person with total control of the contract prior to the annuitant’s death. In most instances, the owner will be one person, the person whose money buys the contract. Other forms of ownership may be desirable in limited circumstances.

**Joint ownership and taxes-**Joint ownership was more common in the past than today. Previously, a parent, age 50, might buy a deferred annuity with a child, age 25, as the joint owner and annuitant. The parent set the maturity date at the annuitant's 85th birthday. The child owned the contract after the parent's death and income tax deferral of up to 60 years was possible.

The Tax Reform Act of 1986 amended Internal Revenue Code (IRC) Section 72(s)(1) to require annuity contracts be distributed within five years. The law effectively disallows long periods of tax deferral through joint ownership arrangements.

A joint annuity is a joint tenancy with right of survivorship. Joint ownership may cause adverse gift and estate tax consequences. If a party purchases a joint annuity and contributes the entire premium, there is a taxable gift of one-half of the premium to the other owner. At the first owner's death, the contract's entire value will be included in the gross estate unless it is proved the survivor contributed to the contract. A special rule applies to married couples; one-half of the value is included in the estate of the first owner to die regardless of actual contribution.

**Contingent ownership**- The selection of a contingent owner is important if the owner is not the annuitant. The death of an annuitant causes the immediate maturity of the contract. The annuity ceases to exist; all that is left is the death proceeds payable to the beneficiary. Conversely, when the owner dies but the annuitant still lives, the contract continues, but with a new owner. If an owner dies before the annuity starting date, IRC Section 72(s) requires the contract be distributed within five years. This five-year distribution rule does not apply if the spouse is the new owner.

**ii. Rights of Annuity Owner in Owner-Driven Contract**

Before proceeding further it is important to understand three concepts that directly affect annuity contract structuring surrounding the event of death:

- **The Death of the Holder Rule** states that upon the death of a holder, death benefits of the annuity must and will be paid out. The "holder" is synonymous with the taxpayer/owner in any contract.
- **In the case of a non-natural trust-owner,** the annuitant is considered the owner, but only for death distributions. The IRS enacted these contract provisions after January 18, 1985 to prevent generational tax skipping. After April 22, 1987, the provision became applicable to "any holder."
- **The Spousal continuation Rule [IRC 72(s)]** states that the deceased owner's surviving spouse can become the contract owner. The surviving spouse can then continue the contract throughout his or her lifetime and is not forced to take a distribution. If anyone else is named as a primary beneficiary along with the spouse, the option of the surviving spouse becoming the contract owner can be lost.

In cases where a child and spouse are named as primary beneficiaries, some companies will allow spousal continuation but only on the spouse's remaining portion of the contract. The IRC states only that the beneficiary be a spouse; however, some contracts specify that the spousal election letter will only be sent out if the surviving spouse is the “sole” beneficiary, which is a narrower interpretation of IRC. Death benefits can come in two forms:

1. The assets that have accumulated in the annuity investment itself, or,
2. Enhanced death benefits provide the potential of greater payouts based on certain contract guarantees. The enhanced death benefits feature offers another advantage over many other types of investments.

**Owner-Driven-** All annuity contracts are currently "owner-driven" in the sense that, under current law, the death of an owner requires a payout of an annuity, regardless of whether an annuitant is alive. Likewise, the death of an annuitant in most contracts currently issued (annuitant-driven) also requires a payout, per the terms of the annuity. It is the Internal Revenue Code that requires the payout at the death of the owner. The payout at the death of an annuitant is per the terms of the contract; it is the company’s determination of whether there will be a payout at the death of the annuitant. Under an owner-driven contract, only the death of the owner triggers the guaranteed death benefit. Here is an example:
Owner-Driven Contract
Owner: Husband
Annuitant: Wife
Beneficiary: Children
Original Deposit/Guaranteed Death Benefit: $750,000
Current Value: $400,000

Now, if the wife dies, the husband is generally able to name another annuitant without a payout or any other consequences. He simply names another annuitant. There is no step up in the value of the contract though, because it is owner-driven, and the owner did not die.

On the other hand, if the husband dies, then the contract must pay out, even though the wife/annuitant is still alive. Furthermore, since it is an owner-driven contract, the guaranteed death benefit applies. In this case, the children will have a death benefit of $750,000 to for which to select a distribution option.

### iii. Rights of Annuity Owner in Annuitant-Driven Contract

An annuitant-driven means that the contract requires a payout at the death of the annuitant. It is worth noting that there is another substantive point on how annuitant-driven contracts work. It determines when the guaranteed death benefits are applicable**.** In an annuitant-driven contract, generally only the death of the annuitant will trigger the guaranteed death benefit (as opposed to the standard death benefit, the current value). As mentioned above, under an owner-driven contract, only the death of the owner triggers the guaranteed death benefit. Here is an annuitant-driven example:

Annuitant-Driven Contract
Owner: Husband
Annuitant: Wife
Beneficiary: Children

Original Deposit/Guaranteed Death Benefit: $750,000
Current Value: $400,000

If the husband dies, the contract must pay out, per the IRC. However, because the contract is annuitant-driven (and the annuitant/wife is still alive), the standard death benefit of the current value is paid out. Therefore, the children will receive the current value of $400,000 (despite the fact that the annuitant/wife is still alive) for which they must select a distribution.

If the wife dies, then the contract must pay out. Furthermore, because the contract is annuitant-driven, and the wife/annuitant has died, the guaranteed death benefit of $750,000 is payable. However, the death benefit is paid to the children, as primary beneficiaries. Since the husband is still alive, but the children have received the proceeds, this may be deemed a taxable gift from the husband to the children of $750,000 at the death of the wife.

### b. Rights and Obligations of the Annuitant

The annuitant is often characterized as the 'measuring life' under an annuity because the duration of the annuity payments made by the issuer (or the payment of a death benefit before annuity payments begin) may depend on how long the annuitant lives. His or her life measures the benefits under the contract.

#### i. Entities Eligible for Role as Annuitant

The annuitant is the person who receives annuity benefits at the contract maturity date. The annuitant is always an individual; it cannot be an unnatural person. The annuitant typically has no rights under an annuity contract. Upon the annuitant's death, the contract matures automatically and the cash value is paid to the designated beneficiary. The annuitant can be the same person as the owner. Naming an annuitant other than the owner exposes the owner to two risks: first, the annuitant may predecease the owner, which causes contract maturity and distribution of cash value to the named beneficiary; second, the annuity benefits will be paid to the annuitant, not the owner, on the annuity starting date. Few companies accept joint annuitants. In any event, there is no reason to use this designation. Naming an annuitant other than the owner is justified only if the proposed owner is older than the maximum age permitted by the insurance company, age 75 years, for example. If the proposed wants to own an annuity, he or she must name some younger annuitant, such as a child.

#### ii. Role of Annuitant in Owner-Driven Contracts

By "driven" it is meant that certain actions occur upon death that are beyond the control of named parties to the contract. In an Owner Driven contract, owners have all legal rights, and can change the designated annuitant as needed without any negative tax or penalties, as the contract specifies. Owner Driven contracts pay out only upon the death of the owner.

### iii. Role of Annuitant in Annuitant-Driven Contracts

In an Annuitant-Driven contract, owners can usually be changed. It is contract specific as to whether an annuitant can be changed once the contract is issued. Also, the contract will pay out upon the death of either the owner or the annuitant. In either form of contract, Owner-Driven or Annuitant-Driven, changes to beneficiaries (primary or contingent) may always be made. A key to death benefit payouts is to know on whose life the enhanced benefits are actually based. The owner or the annuitant can trigger enhancement of death benefits.

- Owner-Driven contract, death benefits are based on the death of the owner.
- Annuity-Driven contract, death benefits are based upon the death of the annuitant.
  - On the owner's death, distributions will occur as "distributions of annuity assets."
  - On the death of the annuitant the distributions will come out in the form of "death benefits" (enhanced or not).

The different handling can bring about adverse income tax, gift tax, and premature distribution penalties to various named parties to the annuity contract.

## 2. Charges and Fees

Annuity contracts will designate a minimum premium that the policyowner must pay to purchase an annuity. Normally these amounts are in the $5,000–$10,000 range for single-premium policies and $25–$50 per month for flexible-premium policies. Insurance companies may designate a different minimum amount, depending on the type of funds the client places in the annuity. For example, a policy might show a minimum premium of $1,000 for a qualified single-premium annuity but still keep the nonqualified annuity minimum premium at $5,000. Lower premium amounts are common for qualified contracts so that the annuity can accept small annual IRA contributions. Deferred annuities may charge a nominal annual contract maintenance fee such as one percent of the cash value not to exceed $20–$50. These fees are usually deducted from the annuity cash values, and they will often expire when the contract accrues a certain amount of cash value such as $5,000 or $10,000. Recent competition among annuity products, however, has made this contract provision less common in newly issued annuity contracts.

## 3. Interest Rates Strategies

The amount of interest the annuity product earns is of primary importance to the owner of the policy. In addition, because the initial interest rate is guaranteed for some period of time in the terms of the contract, the length of the guarantee period is critical. A potential annuity purchaser needs to know how the insurance carrier has typically treated its policyholders in terms of renewal interest rates. These are the interest rates declared once the initial guaranteed interest rate period has expired.
Two questions a person should ask when considering the purchase of an annuity are;

- What is the current interest rate being paid?
- For what length of time is that interest rate guaranteed? Will it be one year, two years, five years, or longer?

The length of time the annuity will pay the initial interest rate is important. Purchasers need to know how long they can count on the insurance company paying the higher initial interest rate. Often, the interest rate guarantee period is tied to the length of the annuity's surrender charge period. Fixed-interest deferred annuity contracts will also provide a minimum interest rate, and the insurance company guarantees that it will never credit an interest rate less than this percentage to the annuity. This rate has typically been 3 %. Interest rates in the economy fell towards 1% in the first half-decade of the 21st Century. Although a boon for contract holders, the 3% guaranteed rates caused insurers to see more money go out the window than was coming in the front door. The result has been a movement to tie minimum interest rates to economy-wide rates, not set them in stone.
**Bonus Interest Rates-** Discussed in Section A 1 above, these are extra amounts of interest granted to new purchasers that are paid in addition to the normal stated current interest rate. Based on the total dollars contained in the contract during its first year, these rates are designed to attract money from existing annuity contracts. The agent and the potential purchaser should be well informed regarding any bonus interest rates. Bonus rates are enticements. Bigger enticements usually mean bigger constraints down the road when that bonus will be applied or earned. Forfeiture or withdrawal prior to the end of the surrender charge period could void the bonus

## 4. Crediting Methods

Companies use several methods to establish the current interest rate to be credited to their accumulation accounts.

### a. Portfolio rates

The portfolio average method credits all policyholders with a composite rate of interest that reflects the company's earnings on its entire portfolio of investments during the year in question. During periods of rising interest rates, the interest credited to the "new" contributions received during the year will be heavily influenced by the interest earned on investments attributable to "old" contributions, those received and invested 5, 10, 15 or more years earlier. The interest credited will therefore be stabilized. Thus, when interest rates are rising, contributions made in the year 199X earn 4%, funds placed in the accounts (old or new) in year 199Y earn 4.5%, and all funds in year 199Z earn 5%. When interest rates are falling, contributions made in the year 200X earn 4%, funds placed in the accounts (old or new) in year 200Y earn 3.5%, and all funds in year 200Z earn 3%.

### b. New Money Rates

With new money rates (sometimes referred to as the 'banding'), the contributions made by all policyholders in any given period are banded together and credited with a rate of interest consistent with the actual yield that such funds obtained during that period. If a company's average return on all money is 4% in a given period, the contributions made by all participants during the current period may be credited with 5% if the company was able to make new investments that, on average, returned in excess of 5% interest. Additionally, the interest rate credited on those contributions should continue to earn 5% until the monies are reinvested. After reinvestment, the interest on these contributions will change and the rate credited to contributions banded in the following period could be higher or lower.

With increasing interest rates and reinvestment of assets every year, an investment in year 199x might earns 5% (the new money rate for that year) and then earn 5.25% in the second year and 5.5% in the third year. An investment in year 2 earns 10% (the new money rate for that year) and then earns 10.25% in the second year and 10.5% in the third year. Finally, an investment in year 3 earns 11%.

## 5. Minimum guaranteed Interest Rates

The Standard Nonforfeiture Law (SNFL) for annuities was developed by the NAIC in the late 1970's. The model law mandates a 3% minimum guaranteed interest rate for fixed annuities. This minimum caused solvency concerns to emerge among insurers offering annuity products as interest rates drifted lower through the first half-decade of the beginning of the 21st Century. Many of the investments of life insurers do not provide yields sufficient to support a 3% guaranteed yield. California AB 284 (2003) is legislation that addresses the issue. The bill provides a uniform method of calculating minimum nonforfeiture amounts. It modifies the interest rate applicable to accumulations under annuity contracts, the amounts by which those accumulations may be decreased, and the minimum amount of considerations used to determine the minimum nonforfeiture amount. The new provisions apply to contracts issued on and after January 1, 2006, but insurers apply them, on a contract-form-by-contract-form basis, to any contract issued on or after January 1, 2004. The bill also allows the Insurance Commissioner to adopt regulations to implement the provisions.

The mechanics of rate determination can be outlined as follows:

The minimum nonforfeiture amount at any time at or prior to the commencement of any annuity payments shall be equal to an accumulation up to that time, at the **rates of interest indicated below**, of the net considerations paid prior to that time, decreased by any prior withdrawals or partial surrenders, an annual contract charge (currently $50), and state premium tax paid by the company for the contract, and any loans or indebtedness outstanding. The net considerations for a given contract year used to define the minimum nonforfeiture amount is 87.5 percent of premium during that contract year.

**Interest rates-** The interest rate used in determining minimum nonforfeiture amounts is the lesser of 3% or the following:

- The five-year Constant Maturity Treasury Rate reported by the Federal Reserve as of a date, or averaged over a period, rounded to the nearest one-twentieth of 1 percent, no longer than 15 months prior to the contract issue date or redetermination date, reduced by 125 basis points, where the resulting rate is not less than 1 percent.

- The interest rate applies for an initial period and may be redetermined for additional periods. The redetermination date, basis, and period are to be stated in the contract.

If a contract provides substantive participation in an equity-indexed benefit, it may increase the reduction described above by up to an additional 100 basis points to reflect the value of the equity index benefit. The present value at the contract issue date, and at each redetermination date thereafter, of the additional reduction may not exceed the market value of the benefit. (Section 10168.25)

## C. Contract Provisions Common to Variable Annuities

As the name implies, with a variable annuity the annuity holder receives varying rates of return on the funds placed in the annuity. The return is dependent on the risk taken by the annuity holder and the economic performance of the various components of the annuity portfolio.

### 1. Variable Options

There are several contract provisions common to variable annuities. Not all annuities will contain all provisions. It is important that the purchaser understands the several options available and makes an informed decision about which features he or she wants.

#### a. Equity-Based

Equity-based guarantees refer to applying equity indexes as an option in the valuation of the accounts. Some form of guarantee as to the minimum value is made by the insurer regarding the value of the portfolio held by the annuitant in the variable accounts. Such products are relatively new. The insurance industry has had limited experience in setting and implementing reserves for products containing equity-based guarantees. Furthermore, limited data on policyholder behavior makes it difficult for actuaries to develop methodologies for price and evaluate these products."

#### b. Risk-Based

This feature refers to interest rate risk. An interest rate guarantee based on bond or interest rate indexing is designed to guarantee the minimum value of the variable accounts in the variable annuity. Inflation, which is uncertain when the annuity is purchased, can reduce the real value of the annuity payout. The absence of markets for purchasing power-adjusted annuities has been pointed out as one of the important rationales for government-provided retirement income programs[2]. The introduction of Treasury securities which guarantee returns after inflation may lead to changes in this situation, and in particular, may facilitate the introduction of purchasing-power-adjusted annuities by some insurance companies.

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[2] "A Framework for Social Security Analysis," Peter Diamond *Journal of Public Economics*, vol. 8, no. 3 (1977), pp. 275-298.

## 2. Fixed Options

When a variable annuity is issued, the policy owner has a 30-day cancellation period. The insured can return the policy to the insurer any time during the 30-day period. During the 30-day cancellation period, the premium for a variable annuity may be invested only in fixed-income investments and money-market funds, unless the investor specifically directs that the premium be invested in the mutual funds underlying the variable annuity contract. (Section 10127.10)

## 3. Charges and Fees

The charges and fees under a variable annuity are different from those found in fixed annuities. This comes from the fact that variable annuities are subject to a greater degree of regulation because variable annuities are considered to be securities. The prospective purchaser of a variable annuity must be given a prospectus. Also, agents who sell these products must maintain a Securities and Exchange Commission license to sell securities, in addition to the state-issued license. Fees commonly charged to holders of variable annuities include;
Companies can charge a fee for each variable investment account to cover the extra management expenses associated with the particular account.
A mortality expense, generally 1%, is deducted proportionately from each of the variable accounts as well.
There can be a fee for switching between accounts or funds offered by the variable annuity. Annuity holders can transfer funds from the guaranteed account to (or between) variable accounts. A certain minimum number of such transfers might be gratis, after which fees apply. The issuer can also regulate timing or frequency of jumps between accounts.

## 4. Dollar Cost Averaging

This is a system of buying securities on a regular basis with a fixed dollar amount at regular intervals. Dollar cost averaging helps eliminate the worry of catching the market at the right time. With dollar cost averaging, money is invested gradually, at regular intervals, into professionally managed portfolios. This allows the policyholder to take advantage of market highs and lows, buying more shares when the price is low and fewer shares when the price is high. A key benefit is that over time, the average per-unit cost will normally be lower than either the high or the average price.

Here is a simple example to illustrate how dollar cost averaging works. A person consistently invests $100 each month for three months. The investment chosen initially costs $10 per share. In the first month, this means 10 shares are bought. Then the next month, the market drops. This is not necessarily bad news. Even though the shares purchased last month for $10 are now only worth $8, one needs to remember that consistent $100 investments per month are being made. Because the price has dropped, the monthly $100 now buys 12.5 shares instead of 10.

**Annualized Interest Rates and Fixed Account Bonuses-** Bonus interest rates are extra amounts of interest granted to new purchasers of fixed-interest deferred annuities that are paid in addition to the normal stated current interest rate. These amounts are usually based on the total dollars contained in the contract during its first year. Bonus plan annuities are designed to attract money from existing annuity contracts, which still may be subject to a surrender charge, by paying extra interest in the first year. This extra interest (the bonus) is designed to offset some of the loss caused by the termination of the old policy. Potential purchasers must understand that these bonuses have an indirect cost behind them. Thus, the agent must be sure to tell prospects of any circumstance in which the bonus will not be paid, such as early termination or surrender. Interest rate bonuses often encourage replacement of annuities. The policyowner is lured by the high interest rate and a bonus above the normal current interest rate; the annuity owner may feel that the bonus will help to offset any surrender penalties he or she may incur. Bonus annuities will bear much higher surrender charges than a nonbonus product, putting the policyowner at a still greater disadvantage.

## 5. Death Benefit Guarantees

For variable annuities, the death benefit shall be at least equal to the cash surrender benefit. The cash surrender benefits are not to be less than the present value of that portion of the maturity value of the paid-up annuity benefit which would be provided under the contract at maturity arising from considerations paid prior to the time of cash surrender, reduced by prior withdrawals or partial surrenders of the contract. The present value is calculated on the basis of an interest rate not more than 1 percent higher than the interest rate specified in the contract for accumulating the net considerations to determine the maturity value, decreased by indebtedness including interest, and increased by any existing additional amounts credited by the company to the contract. Cash surrender benefit cannot be less than the minimum nonforfeiture amount. (Section 10168.4)

## 6. Living Benefit Guarantees

Insurance companies offer living benefits that give principal protection throughout the entire term of a variable annuity contract. The living benefits come in several forms:

- The guaranteed minimum income benefit, which guarantees a minimum level of income at annuitization
- The guaranteed minimum accumulation benefit, which guarantees a minimum account value at some point in the future
- The guaranteed minimum withdrawal benefit, which guarantees a minimum stream of income, equal to return of the variable annuity owner's principal, if withdrawn within specified limits over time.

**Examples A-D** in this book look at information addressing sales and marketing practices. Some of these scenarios have resulted in sanctions. In others, readers can judge for themselves.

**A Bad Image-** Unfortunately, nearly since the first annuity commission check was cashed, complaints have been made against annuity sellers and selling practices. Even the most reputable of insurers stand accused. Perhaps the nature of annuity policies, that they are ‘reverse insurance,’ confuses both agents and buyers, leading to false impressions. Anecdotal reports tell us that some unethical agents are drawn toward policies sold to the elderly because they are often vulnerable to scare tactics and pressure pitches. Policy lapses are yet another concern in the marketing of annuities. Such problems and practices result in bad press.

## Example A

## Securities Industry Association Conference

Current NASD [National Association of Securities Dealers] Regulatory Issues on Sales and Marketing
Elisse B. Walter
27th Annual SIA Sales and Marketing Conference 09/28/2004

**Introduction**

Thank you so much for inviting me to speak with you. I've been a regulator for - please don't gasp - 27 years and, if I've learned anything, it is that good communication between the industry and its regulators is vital to both sides of that equation. I'm pleased that we can play a small part in that effort today.

This morning I'd like to touch on a number of regulatory issues that we at NASD have been wrestling - issues that directly affect what you do in selling products to your customers. I'll try to give you an idea of what crosses the line into forbidden and unethical behavior. While none of us - just like our kids - like to be reminded of what we are not supposed to do, it is a pretty good way to stay out of trouble - or at least to understand what kind of trouble you are facing. But, we at NASD also try to work closely with the industry and give as much guidance as we can so you can spot issues BEFORE they become problems. I'll touch on those aspects of our work as well. Most important, I want to emphasize that our phone lines are always open. Feel free to call me or my colleagues if you'd like to talk about a question that concerns you, or even if you want to complain. This is a tough environment for your business, and a tough environment in which to be a regulator. Let's make it a little easier by working together where we can.

I was told that you have an interest in four main areas - mutual fund sales practices and fee disclosure, variable annuity sales practices, branch office supervision, and fee based accounts - I will comment on each. [After the speaker’s comments on mutual funds comes the segment pertinent to this discussion.]

### Variable Annuity Sales Practices

The second major area that I want to cover is variable annuity sales practices.
We have locked our focus onto variable annuities, and have been prodding, probing, and diagnosing their sales through examinations and enforcement cases for a while. We are now operating to cut a new rule on deferred variable annuities that the comment period has just closed on. But our case history should start five years ago.

In 1999, NASD's industry committees and NASD staff were sufficiently concerned about industry practices in selling variable annuities that we published best practice guidelines covering disclosure, suitability, account opening and sales practice issues for variables.

But since then, it has become clear that while some firms embraced the best practice guidelines, many did not, and our exams have raised more and more red flags.

To bring you up to recent times, in May of last year, we issued a press release that detailed variable annuity abuses and announced an Investor Alert on them. In addition to announcing settlement of an action relating to failure to handle customer complaints properly, that release discussed three suitability complaints involving variable annuities that we thought were pretty egregious. For example, we cited the sale of a deferred variable annuity to a high school senior so that she would have a safe place to put her money, which she would need right after college for a house or a car. I know that these things are often sold to seniors, but not usually to high school seniors. We worry about sales to all seniors, including the high school kind: she didn't need a death benefit or tax deferral, and she certainly didn't need the tax penalty and surrender charges she would have incurred to buy that car with that annuity.

This year, we have brought a number of important enforcement actions in this area, three in January alone.
In January we fined Prudential Securities $2 million and ordered it to pay customers $9.5 million for annuity sales and switches that violated New York State insurance regulations that ensure investors will not be pressured into making spur of the moment decisions on annuity switches.

Also in January, we permanently barred a Louisiana broker from the industry and ordered him to pay more than $1.5 million in restitution for making unsuitable annuity sales to older, conservative investors.

And again in January, we filed a case, which is being litigated, against Waddell & Reed and two of its senior executives, charging the firm with recommending 6,700 annuity exchanges to its customers - generating $37 million in new commissions and costing the customers $10 million in surrender fees - without determining whether the transactions were suitable.

In April we fined Long Island brokerage firm David Lerner Associates $100,000 for prohibited variable product sales contests.

In May we disciplined Nationwide Investment Services, Nationwide Securities and American Express and three brokers for variable annuity abuses. Nationwide was fined for inadequate variable annuity sales procedures and systems, as well as using sales literature that didn't make required disclosures about the annuities. American Express failed to keep records as required by SEC rules, which was discovered in an investigation of a former registered representative who converted client funds. The three brokers, who were with other firms, were barred or suspended for conversion, forgery, misrepresentation, and unsuitable sales.

In June we fined Davenport & Company for deceptive market timing in variable annuities.

And, these are just the most recent of the drumbeat of more than 80 disciplinary actions NASD has taken in response to troublesome variable annuity sales practices in the last two years. We brought these cases against practices such as: persuading investors to switch with no reason, causing them to incur unnecessary surrender fees and commissions, recommending that investors buy deferred annuities within their IRAs without disclosing that there is no tax advantage beyond those that the IRA provides, and selling an annuity with a death benefit without telling the investor that the death benefit's value is subject to reappraisal some years down the road, based on then prevailing market conditions.

But we haven't just been bringing cases. This June we issued a joint white paper with the SEC on the findings of our examinations of brokers who sold variable products. That report identifies both sound and weak practices in sales suitability, disclosure, supervision, training, and records management.

And, to build to a crescendo of sorts, we published our new rule proposal in a June Notice to Members. The proposal includes heightened disclosure requirements for delivery of not only a prospectus, but also a plain English risk disclosure document, highlighting the key features of the annuity.

The proposal also requires that before a broker can effect a transaction, it would have to be approved by a registered principal after considering specific factors such as whether the investor's age or liquidity needs make a long-term investment inappropriate. The principal must also approve in writing the suitability analysis for the annuity sale or exchange. The suitability analysis must also include a determination that the variable annuity as a whole and its underlying subaccounts are suitable.

The comment period closed at the beginning of August. We have received many negative comments letters - not particularly surprising - but we also have been told that these ideas represent what firms really should be doing already. We are analyzing, ruminating on, and working through the issues to ensure that the sales practices in this part of the market serve investors better.

## D. Contract Provisions Common to Indexed Annuities

Two features that have the greatest effect on the amount of additional interest that may be credited to an equity-indexed annuity are the indexing method and the participation rate. It is important to understand the features and how they work together. The following describes some other equity-indexed annuity features that affect the index-linked formula.

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Other features of equity index annuity contracts vary from product to product.
**Premium Payments-** The majority of products on the market are single premium deferred annuities, with the purchaser making one premium payment that is accumulated for some period prior to payout. Some insurers offer flexible premium deferred annuities, permitting multiple premium payments in amounts determined by the purchaser, and immediate annuities, providing for immediate commencement of the payout
**Floor Guarantee-** The guaranteed minimum return for a single premium product typically is 90% of premium accumulated at a minimum interest rate. Accumulation was at a 3% annual rate of interest, but as discussed in IV B 5 “Minimum Guaranteed Interest Rate” this is going to eventually change to a floating rate.

### 1. Primary Interest Crediting Strategies

The index-based return depends on the particular combination of indexing features specified in the contract. The return of equity index annuities is typically based on the S&P 500 Index, but other domestic and international indices are also used. Some products permit the contract owner to select one or more indices from a specified group of indices. Index growth generally is computed without regard to dividends. There are several methods for determining the change in the relevant index over the period of the contract. The most common indexing features are described below
The "point-to-point" method compares the level of the index at two discrete points in time, such as the beginning and ending dates of the contract term.
The "high water mark" or "look-back" method compares the highest index level reached on specified dates throughout the term of the contract (e.g., contract anniversaries) to the index level at the beginning of the contract term.
The "annual reset," "cliquet," or "lock-in" method compares the index level at the end of each contract year to the index level at the beginning of that year, with the gain for each year "locked in" even if the index declines in the following year. Averaging techniques may be used with these formulas to dampen the volatility of index changes. For example, in the point-to-point method, the ending index value could be computed by averaging index values on each of the final 90 days of the contract term.

#### a. Monthly Averaging

This method uses the monthly closing market levels to determine the index level at the end of the contract term. The interest rate provides a return equal to the monthly average S&P of the previous year, times a participation rate which is then adjusted, as dictated under the contract, to be not less than zero- or other floor- nor higher than the CAP or maximum rate (say 14%). Suppose in year 1, the S&P goes up 20%- the client would get not 14% but about half that due to averaging. In the second year, the S&P did a -10%, but the client would just show no return at all due to the zero floor. In year 3, the S&P went up 20%- the client would get about 7%.

**b. Point to Point**

The point-to-point design credits interest based on the difference between the index value at the beginning and end of a period of at least one year. The change in the index is a "price change only" measure and does not reflect dividends. For example, the S&P 500 Index is at 900 and at the end of the crediting period the index result is 1,100. A gain of 22 percent is realized. The point-to-point design can be annual with an annual reset, or over a longer period of time, also known as a term point-to-point, that normally ranges from 7 to 12 years without a reset. The point-to-point term method works best in upward-trending markets over time, whereas the point-to-point with annual reset tends to work best in uncertain and volatile markets.

**i. Annual**

The annual point-to-point method calculates the interest return every contract year. It eventually combines these returns to arrive at the total return for the contract term. This method resets the starting point for the calculation each year on the contract anniversary and allows the owner to take advantage of economic upswing after a period of market loss or correction.

**ii. Long-Term**

The long-term point-to-point method compares the level of the index at two discrete points in time, such as the beginning and ending dates of the contract term in the point-to-point method, the ending index value could be computed by averaging index values on each of the final 90 days of the contract term. An example is 7 year, point-to-point, based on the S&P 500, using 6 month index averaging, with 80% participation, and a guaranty of 100% accumulating at 3%. Point-to-point methods credit interest as a portion of the percentage growth in the underlying index from the beginning of the term to the end of the term. Long term averaging may be used at the end of a multi-year point-to-point benefit determination, that is, when the index benefit is determined solely upon the change in the index from the beginning of the index term period to the end of the index term period, which could be up to ten years.  Such averaging might be over a period of 2 to 24 months and commonly might use the average of monthly indices, Index-based interest is credited to the contract value either when it is calculated or at the end of the term. Interest in point-to-point contracts invariably is credited at the end of the term because its amount is unknown until then.

### c. High Water Mark

This method of calculating the value of the index uses a fixed starting point to begin the computation. It does not reset the starting point of the index calculation periodically as other indexing methods might do. The annuity holder with this type indexing will only see positive interest appreciation when index levels are above the index point at the beginning. High water methods credit interest as a portion of the percentage growth in the underlying index from the beginning of the term to the highest value the index has achieved at specified measurement points up to the end of the term. Typically, these measurement points are the anniversaries in the contract, but they could occur with greater frequency. Each of these measurement points could use some averaging technique.

### d. Annual Resets

This type of annuity calculation is also known as the ‘ratchet’ method. The annual reset design credit index-based interest to the current contract value on an annual basis. Most ratchets operate annually; however, less frequent application is possible.

### e. Combination Methods

The following variations of the design are used for the reset/ratchet method. The discussion above pointed out other combinations.
**Method of accumulation-** A compound ratchet applies the index-based interest rate to the current contract value at the time of the crediting. A simple ratchet applies the index-based interest rate to the premium minus cumulative withdrawals at the time of the crediting.
**Length of guaranty of index change recognition**-.The current participation rate, spread charge, or cap can be guarantied for the entire term, only for the current interest crediting period, or for some intermediate period. If the guaranty is only for the current interest crediting period, a lesser guaranty commonly is provided for the balance of the term and subsequent terms.
**Annual averaging of index values within each year-** This is used for ratchet designs to reduce the volatility in the interest credited to the contract. Another result is that a nominally higher portion of the calculated index increase rate is reflected in the interest rate. Methods used are daily averaging, monthly averaging, and quarterly averaging. These methods reflect on average half to slightly more than half of the annual index increase percentage; however, the portion will vary considerably from year to year depending upon the profile of the index volatility during the year. Ratchet Payment guaranties provide an increase over the most recent annuity payment if equity index based interest exceeds the assumed interest rate. This is analogous to a ratchet benefit in a deferred equity indexed annuity.

## 2. Spreads

In some annuities, the index-linked interest rate is computed by subtracting a specific percentage from any calculated change in the index. This percentage, sometimes referred to as the "margin," "spread," or "administrative fee," might be instead of, or in addition to, a participation rate. For example, if the calculated change in the index is 10%, the annuity might specify that 2.25% will be subtracted from the rate to determine the interest rate credited. In this example, the rate would be 7.75% (10% - 2.25% = 7.75%). In this example, the company subtracts the percentage only if the change in the index produces a positive interest rate.

### 3. Cap Rates

The cap rate operates to limit the amount of growth in the applicable market index that will be credited to the equity-indexed annuity. The cap is an upper limit on the amount of growth that can be passed on the annuity holder. The cap rate is expressed as a percentage. For example, an equity-indexed annuity with a participation rate (discussed in the next segment) of 100% might provide that a maximum of 12% of the gain in the index will be passed on to the value of the contract.

### 4. Participation Rates

In an equity-indexed annuity this is the amount or percentage of the increase in the market index that will be paid on the principal. The participation rate is a multiplier applied to the percentage increase in the index in order to determine the index-based interest rate. Participation rates are dependent upon interest rates and call option costs and, consequently, are determined separately at the beginning of each period during which they are guarantied. The highest participation rates are for point-to-point products and lowest for ratchet products. In some contracts, the participation rate, frequently between 75% and 110%, is multiplied by index growth to determine the applicable share of index appreciation to be credited. The participation rate is typically set at the time the annuity is purchased and may be reset either annually or at the start of the next contract term. Other contracts specify a percentage, called the "margin" or "spread," that is subtracted from index growth to determine the applicable share of index appreciation to be credited.

### 5. Minimum Guaranteed Interest Rate

Equity-indexed annuity contracts provide a minimum guaranteed interest rate of 3% as prescribed by law. This will eventually will change to a rate itself tied to an index that more realistically reflects interest rates in the economy.

### 6. Impact of Premature Surrender Charges

As with other annuity contracts, surrender charges are required if the contract is given up before a specified period of years. The idea is to make it less tempting for annuity owners to draw funds out of the contract and allow the insurer to recover costs associated with the contract. Surrender charges are commonly deducted from withdrawals, but these charges often are eliminated for a 30 to 45 day window at the end of each index term. There may also be a limited free withdrawal privilege.

### 7. Charges and Fees

A contract maintenance charge is ordinarily deducted each year from the value of an annuity. Other administrative charges can be deducted at an annual rate stated in the contract. This can amount to over 1% of the contract's value annually. Other charges can apply for the death benefit or any other options chosen at the time the contract is executed.

## E. Available Riders

A rider is a written agreement attached to an insurance policy or annuity contract that limits or expands the policy's terms or coverage. Riders may increase the premium paid to the insurance company. Strictly speaking, a rider is documentation attached to an existing policy that augments or deletes from policy provisions. It is generally used to extend coverage for some specific reason. Endorsements are themselves often standardized. Basically, endorsements or riders are the documents used to shape the standardized policy to fit individual needs.

### 1. Life Insurance Rider

A life insurance rider would be just that. An increased, separate, amount would be paid for life insurance protection in some amount. Such insurance could feature an accelerated benefit option that allows for the early payment of some portion of the policy's face amount should the insured suffer from a terminal illness or injury. Any direct coupling of whole life insurance and an annuity contract would seem to fly in the face of the Supreme Court's decision in *Helvering v. Le Gierse*[3], where just such a coupling was decided to be a hedging or investment transaction, not insurance.

**Tax-qualified term life-** Tem life as a part of an annuity contract is considered incidental life insurance. If all of a person's 403(b) accounts invest only in mutual funds, then he or she has no incidental life insurance. If someone has an annuity contract, a portion of the cost of that contract may be for incidental life insurance. If so, the cost of the insurance is taxable to the individual in the year contributed and is considered part of the basis when distributed. The employer will include the cost of a person's insurance as taxable wages in box 1 of Form W-2. Not all annuity contracts include life insurance. If it does, the plan participant will need to figure the cost of life insurance each year the policy is in effect.

**Figuring the cost of incidental life insurance**. If it is determined that part of the cost of an annuity contract is for an incidental life insurance premium, he or she will need to determine the amount of the premium and subtract it from the includible compensation.

[3] (1941) 312 U.S. 53

To determine the amount of the life insurance premiums the individual will need to know the following information.

- The value of the life insurance contract, which is the amount payable upon the named insured's death.
- The cash value of the life insurance contract at the end of the tax year.
- The taxpayer's age on his or her birthday nearest the beginning of the policy year.
- The current life insurance protection under an ordinary retirement income life insurance policy, which is the amount payable upon death minus the cash value of the contract at the end of the year

## 2. Long-Term Care Benefits Rider

Annuities can have riders that meet a future need. An annuity with a long-term care rider that will pay for nursing home costs is an example of a rider that addresses a future concern. A long-term care rider fill the bill among consumers because it provides for two needs; provides the prospect of a stable retirement income while protecting against the financial risk associated with chronic long-term health problems. Many LTC riders are similarly constructed, providing coverage for catastrophic illnesses that require home health care, like an in-home nurse or aide, or long-term hospitalization, or a nursing home stay.

### a. Terms of Riders

These riders are designed to provide benefits without cutting into the monthly payments received from an annuity. Thus, a long-term care rider on an annuity can provide great coverage in the event of an accident or unplanned illness. As with any added benefit, however, the cost can be a drawback. There can be minimum deposits required, sometimes ranging from $30,000 to $50,000 for the initial product purchase. Many annuities with long-term care riders require that the annuity be held for a certain term, such as 7-10 years. It is important that careful attention is given to how the contract defines "catastrophic" or "chronic" illness.

### b. Difference Between Crisis Waivers & Long-Term Care Riders

Strictly speaking, a waiver is an intentional and voluntary surrender of some known right, which generally may either result from an express agreement or can be inferred from circumstances. It is the relinquishment of a known right that may result from either the affirmative acts of the insurer or its authorized agents, or from the insurer's nonaction, with knowledge of the applicable facts. In this case, the insured waives ownership rights to the policy in exchange for consideration (the early payment of cash).

Concerning endorsements or riders, these are written modifications of an insurance policy that changes the original, often standardized, contract of insurance. Endorsements may broaden or narrow the original policy language. Strictly speaking, a rider is documentation attached to an existing policy that augments or deletes from policy provisions. It is generally used to extend coverage for some specific reason.

Endorsements are themselves often standardized. Basically, endorsements or riders are the documents used to shape the standardized policy to fit individual needs. At least one form must be added to the insuring agreement and the terms and conditions in order to structure a complete contract. In this case, the addition is the long-term care coverage.

## 3. Loan Provisions

As mentioned in the first section, a loan provision may be included in an annuity contract. In general, this feature allows one to borrow up to a specified amount of the annuity's accumulated value.

**Amount not received as an annuity-** If a loan is received under an annuity contract, the amount received is treated as an amount not received as an annuity and included in current income. This is true whether the amount is received directly under the contract from the insurer or indirectly from another source. Any assignment or pledge of an annuity contract used to obtain a loan from a third party is considered to be an amount not received as an annuity.

**Loans Treated as Distributions-** If a person borrows money from his or her retirement plan, the loan must be treated as a nonperiodic distribution from the plan unless it qualifies for the exception explained below. Further, it applies if a person renegotiates, extends, renews, or revises a loan that qualified for the exception below if the altered loan does not qualify. The taxable part may be subject to the additional tax on early distributions. It is not an eligible rollover distribution and does not qualify for the 10-year tax option.

**Exception for qualified plan, 403(b) plan, and government plan loans.** At least part of certain loans under a qualified employee plan, qualified employee annuity, tax-sheltered annuity (TSA) plan, or government plan is not treated as a distribution from the plan. This exception applies only to a loan that either:

- Is used to buy an individual's main home, or
- Must be repaid within 5 years.

To qualify for this exception, the loan must require substantially level payments at least quarterly over the life of the loan. If a loan qualifies for this exception, it must be treated as a nonperiodic distribution only to the extent that the loan, when added to the outstanding balances of all the participant's loans from all plans of the employer (and certain related employers) exceeds the lesser of:

1) $50,000, or
2) Half the present value (but not less than $10,000) of the nonforfeitable accrued benefit under the plan, determined without regard to any accumulated deductible employee contributions.

# II The Senior Market

How are senior citizens doing financially? In answering this question, it is a mistake to assume that all senior citizens are wealthy; it is equally wrong to assume that all seniors are poor. Seniors are an economically diverse group, and the incomes received are far from uniform.
In 2000, 15% of seniors 65 and older had incomes under $10,000. At the other extreme, 15% of seniors had incomes of $50,000 or more. The median income for all seniors in 2000 was $18,965. (SSA *Income for the Population 65 and over)* This amount is relatively low and may be insufficient for those with substantial additional expenses, such as high or uninsured medical bills, the cost of long-term care in a nursing home, or high property taxes. In addition many seniors live in poverty. In 1997, 12.7% of senior citizens had incomes below the poverty line. (Overview of Entitlement Programs, GPO).

## A. Risk and the Senior Client

Risk is traditionally defined in terms of uncertainty, the uncertainty concerning the occurrence of a loss. The major risk associated with old age is insufficient income during retirement. When workers retire, they lose their normal work earnings. Unless they have accumulated sufficient financial assets on which to draw, or have access to other sources of retirement income, such as Social Security or a private pension, they will be confronted with a serious problem of economic insecurity. Retired persons generally own insufficient financial assets. Financial assets are important since investment income can supplement any retirement income, and the assets provide a cushion for emergencies.
The median net worth (excluding home equity) in 2000 for households age 65 or older was $108,885. Additionally, there is also a wide dispersion in assets owned by the elderly. In 2000**,** the bottom fifth of the households age 65 or older had a median net worth of only $3,500 excluding home equity. In contrast, the top fifth of senior households had a median net worth of $328,432, excluding home equity. (US Census Bureau Data). Thus, many retired persons do not receive substantial amounts of investment income from financial assets that would materially enhance their financial security during retirement.

## B. Pre-retirement vs. Post-retirement Planning

The pre-retirement stage of life can cover the years from age 50 to age 65. During this time of life, families become "empty nesters," and their children have moved into adulthood. Beside the feelings wrought by such a change, the reality is that the years have passed quickly and that retirement is on the horizon. For far too working adults, their first serious efforts at financial planning for retirement begin during these years. No matter what the age, there is great truth in the principle that it is "never too early to begin planning your retirement finances." When an individual faces the idea of planning, the following questions should be asked about pre-retirement financial planning.

**How Much Money Will be Needed in Retirement? –** People need to plan on living on less money in retirement. But the good news is that many expenses may be reduced.

For instance, a person may need to maintain only one car and may have a reduced need for business attire and entertainment obligations. Housing requirements can normally be reduced as well. In these ways, as well as many others, expenses can be reduced significantly. A goal can be set of initially having a minimum of 70 to 75 percent of pre-retirement income coming in at retirement. Adjustments should be made gradually rather than suddenly. Begin living on less, 3 to 5 years prior to retirement. Finding corners that can be cut, without reducing the quality of life, can be a challenging, but very rewarding, adventure in pre-retirement planning.

**Projecting Retirement Income-** Generally, retirement income will consist of Social Security benefits, pension and/or retirement savings plan benefits, interest and dividend income from personal savings, and post-retirement earnings. Institutions that sell or sponsor retirement savings vehicles can help estimate projected benefits from retirement plans. The Social Security Administration provides a Social Security Statement that can assist in estimating future Social Security benefits. It is important to check Social Security income records for accuracy on a regular basis. Errors cannot be corrected after a certain amount of time.

Local Social Security office can assist in estimating future Social Security benefits. The accuracy of Social Security income records should be checked every 3 years. By calling the Social Security Administration number (1-800-772-1213), individuals may request a form to check their records at no charge.

Inflation is a significant problem for anyone on fixed incomes, because purchasing power diminishes as prices rise. Social Security has a built-in cost-of-living factor, its future may be in doubt in light of federal deficits and future Social Security tax increases to support the system. Inflation affects other fixed income sources as well. Long-term inflationary trends are very difficult to project, but cannot be ignored. The best approach is to put aside as much money as possible before retirement. It is also important that the earnings or returns on invested assets be greater than inflation. Otherwise, the real value of the investment declines.

Post-retirement planning has a commonality with pre-retirement planning; husband your money. This is important because the individual has stopped working, there is no stream of income to supplement savings. Many individuals will face a financial emergency in the retirement years. As preparation, attempts should be made to have a sum set aside in an interest-bearing account. A commitment should be made that these emergency funds are only for a *real* emergency. Small consumer loans and credit cards may be convenient sources of emergency funds, but they carry a very high cost. An adequate emergency fund can eliminate the additional expense of interest. The fund is used only as "a last resort" and every effort should be made to replenish it after it has been accessed.

# C. Financial Concerns

## 1. Social Security

Here is the economic definition of social security: A system of government-financed income transfers designed to effect a distribution of income considered desirable. The main component of most social security systems is welfare benefits, given to those in poverty. It can be done two ways: 1.) by identifying groups that are likely to be poor (the unemployed, the elderly, and the disabled), and giving benefits to them irrespective of their actual income; 2.) by identifying, through some sort of standard, people who are poor.

The Social Security program in the United States is an offshoot of option one above. It is officially called the Old-Age, Survivors, Disability, and Health Insurance (OASDHI) program. Almost 95 of 100 workers are employed in occupations covered by Social Security. There is continued worry that this vast program will eventually run out of money. Still, it keeps on making regular payments to millions of Americans and will (hopefully) continue to do so. The political and economic fallout from a collapse of Social Security is almost unimaginable. The program usually begins payment at age 65, but starts at earlier ages for blind or disabled people. The earlier benefits are at a reduced rate.

**Social Security and Retirement Planning-** As related to retirement, the social security program extends benefits to various classes of family survivors of covered wage earners. Payments are not based on the earnings record of the survivors. It cannot be stressed enough the importance of these benefits. It is the responsibility of the breadwinner's survivors to take maximum advantage of the benefits offered. The reality is that for the vast majority of Americans estate planning consists of applying for social security benefits. The U.S. has an abysmally poor savings rate. For whatever reason, most people live beyond their means. A somewhat larger share of the population can expect both social security benefits and a life insurance payment upon the death of the breadwinner. This is a step in the right direction. The public needs to begin planning. Conservation of a few dollars can result in peace of mind and a more comfortable situation for survivors upon death of the breadwinner.

## 2. Retirement Plan Distributions

"Danger: Lump-Sum Distribution Recipient" Perhaps a placard with this *malis avibus* should be worn by all who receive a large payment from a retirement plan. Surely such a scarlet letter would scare off hucksters, flim-flam fast buck artists, needy relatives, possessors of good deals, etc. who seem to materialize when such events occur. Instead of the sign, those who receive retirement plan distributions should instead be cautious and prudent in their actions. The axiom says, "You will always run out of money before you run out of good deals." This is money that took a career to accumulate; plenty of thought should go into redeploying the assets.

There are a number of options as to how retirement plan distributions can be taken. This would include a worker's vested share of company or Keogh pension or profit-sharing plans (including thrift and savings plans), 401(k)s, IRAs, and stock bonus plans. The options depend (1) on what type of plan the individual is in and (2) whether the employer has limited the plan choices. Essentially, what can be done is:

1. Take everything in a lump sum.
2. Take some kind of annuity.
3. Roll over the distribution.
4. Take a partial withdrawal.
5. Do some combination of the above.

Federal law generally protects retirement assets or accounts against claims of creditors so long as the assets remain in the retirement plan. Exceptions to that protection include unpaid federal taxes, IRA's, Keogh plans where the Keogh owner (or owner and spouse) are the only ones in the plan. Annuities are safe from all creditors except the IRS.

### 3. Investing Retirement Assets

If a lump-sum distribution from a qualified retirement plan is received, what is done with the money has an effect on the tax status of the benefits:
First, no tax is due on any portion of the payment that represents the participant's cost of the plan, premiums paid or after-tax contributions that were made.
The payment can be rolled over into an IRA or another qualified plan. The amount that represents the investment in the contract is not eligible for a rollover, however. The rest (that shown as the taxable amount in Box 2a of Form 1099-R) can be rolled over into an IRA.
Receive the payment in cash, with none of it rolled over. The taxable portion of it will be taxed as ordinary income in the year it is received.
Pay an extra 10% tax penalty if the distribution was made prematurely, generally before age 59½. In any case, 20% of the payment will be withheld for income taxes.

## D. Insurance Concerns

### 1. Health

Poor health is an important personal risk that grows larger as a person ages. The risk of poor health includes both catastrophic medical bills and the loss of earned income. If retired, there is not the promise of going back to work to pay off bills. Hospitalization costs do not stop rising. Unless someone has adequate health insurance or other sources of income to meet these expenditures, financial insecurity or bankruptcy can result.

Insurance needs change significantly with age. In the health arena, surveys confirm that many retirees worry about having a major illness with inadequate hospitalization benefits. It must be understood that Medicare provides both hospitalization insurance and medical insurance. The medical insurance portion is optional and, a monthly premium for it is paid to Social Security. Medicare does not pay for everything and the plan has undergone, and will continue to undergo, many changes. Many private insurance companies offer "Medigap" policies that supplement Medicare. Congress has established federal standards for such policies. Individuals choose from a standard list of ten Medigap packages. Of course, the more comprehensive packages cost more. Life insurance needs change drastically with retirement. At retirement, the primary purpose for purchasing life insurance no longer exists. There is no worry about protecting dependent survivors from the loss of income between the time of death and the time income would have ceased at retirement. If a person has sufficient cash resources to cover final expenses and burial, then there is not much reason for life insurance.

## 2. Long-Term Care

During the working years little thought is given to the financial consequences of long-term disability. The chronic conditions that bring about the need for long-term care at home or in a nursing home can be very expensive. Chronic care differs substantially from what most people associate with medical care. Acute care uses intensive, hospital-based, and often high technology medical services to cure acute manifestations of a disease or injury. Chronic care seeks to enable people with functional limitations to regain or maintain the highest level of independence and functioning possible. Chronic care typically provides both medical care and non-medical assistance from a wide range of caregivers in a variety of settings. Because chronic conditions by definition cannot be fully cured, chronic care also emphasizes long-term assistance and compassionate care. Long-term care insurance is available to prevent the loss of assets resulting from chronic conditions, resulting in a penniless old age.

## 3. Estate Planning

Insurance is one of the most important components of the estate planning process. There is no such thing as an estate where life insurance could not be an integral part. This is so because life insurance is relatively inexpensive, provides an instant estate, is flexible and is a familiar, easily understandable concept for even the most inexperienced client in estate planning. The reality is that, like estate planning, life insurance is one of the consumer’s least favorite topics of discussion. The most obvious reason to buy life insurance is to provide liquidity to pay debts, funeral expenses, taxes, or to provide support for beneficiaries. This is especially true if assets are illiquid in that they cannot be turned into cash readily. This situation is often found with owners of real estate, small businesses, or partnership interests. At death, these assets need to be managed, maintained, and have the mortgages paid. This causes a quick drain of cash. Whether an estate is worth thousands or millions, the use of life insurance is the same: To pay off bills and give the family breathing room after the insured’s death. This is especially so when the insured is the family’s breadwinner and the death terminates the income flow. Insurance has been a part of estate planning for a long time. When a provider's estate is not large enough to provide for dependents, life insurance does the job.

## E. Selling to the Senior Market

The potential of the senior market is huge and growing rapidly. If we include adults age 55 and over, the senior market is projected to exceed 75,000,000 by the year 2010, based on U.S. Census data. This has significant bearing on both for-profit and non-profit marketing efforts. Seniors and pre-retirees who plan now by building the best asset management strategy will reap the greatest benefit from those who market financial products to seniors. Senior-focused selling, active networking and focusing on senior needs, will provide for growth in this market. An understanding the dynamics of this market will benefit the insurance industry. It will also be of assistance to seniors, who will have more information and product choice at their disposal.

Gray hair is appearing at an ever-increasing clip in the workplace. Senior Americans comprise 10 percent of the workforce, but account for 22 percent of the nation's job growth. By 2015, the number of employees over 55 is expected to reach 31.9 million, compared to 18.4 million in 2000. According to the Bureau of Labor Statistics, workers aged 55 and over will increase twice as fast as the aggregate workforce. The senior market is as deep as it is wide. One of its more interesting characteristics is its diversity. In 1996, the baby boomer generation of approximately 78 million began turning 50 at the rate of 300,000 per month. In an unprecedented paradigm shift, both parents and their children are now members of the senior population, with ages ranging from 50 to over 100 and experiences ranging from the Great Depression to Woodstock.

Application of basic sales principles to the senior market should play a key role in a thorough marketing plan with the greatest potential for success. Here are ten key points to remember in dealing with the senior market;

1. Never think that the elderly market is "old." They do not consider themselves old.
2. Never attempt to scare them into buying. Scare tactics turn people off.
3. Always treat them as equals
4. Do not pander or be obsequious. Never talk down; they are not dumb. In fact, they are probably smarter -and richer -than you.
5. Do not hoodwink or con. Seniors are skeptical, they have seen it all before.
6. Do not paint all seniors with a broad brush; they are not all alike. There are several age cohorts above age 50 and numerous niche markets.
7. Guarantees are taken seriously. Seniors fear being taken.
8. Glitz and gaudiness have no place. Seniors are conservative about expenditures as a result of being on fixed incomes.
9. Ads should look like ads. No elaborate *fonts*. Type should be at least 12 point in an easy to follow format, not condensed or spread.
10. As with any other client, treat seniors with respect.

## 1. Product complexity

The stage may be set for a national crisis in retirement planning, as many seniors are underestimating their own longevity and are not saving enough for retirement, according to a recent survey[4]. Questions were designed to test participant's knowledge of retirement and income planning statistics and issues involving longevity and its impact. Consumers are underestimating their own longevity and not saving adequately for their retirement, and this sets the stage for a national crisis in retirement planning. Individuals aged 56 to 65 within at least five years of retirement were asked to respond to a quiz designed to test their knowledge of retirement and income planning statistics and issues in the areas of:

- Longevity and its impact
- Income, expenses, and inflation in retirement
- Annuities as a retirement planning tool
- Long-term care and protection of assets

On average, respondents answered only five of the fifteen questions correctly. This failing score of 33% suggests that seniors have misconceptions about issues affecting their retirement. Specifically, they underestimated the life expectancy of a 65-year old (and how many years they are likely to spend in retirement), and they do not consider longevity a significant financial risk in terms of appropriately planning for their retirement. Further, their answers revealed that they underestimate how much money they should be saving compared to experts' recommendations and that they may intend to withdraw from their retirement savings at levels considered too high. They demonstrated a lack of understanding of the extended time horizon they would be living in retirement and of inflation's full effect on the future value of their money. Their responses also indicated that they underestimate long-term care expenses and do not fully understand annuities – the primary insurance product designed to protect retirees' income.

**Cost Factors in Resource Allocation-**In a dynamically changing economic environment, holding on to assets can become as cutthroat as survival in one of the reality-based television shows; which means that seniors have to continually be on their toes. They must anticipate and assess their need for new products or services in order to stay ahead of the game. Faced with the dilemma of unlimited strategic choices but limited resources, seniors must seek help from representatives of the financial services industry to assist them find the best course of action. There are a variety of consumer costs associated with purchasing insurance or financial products. Product complexity can lead down the path of incorrect decisions and the purchase of incorrect or overpriced annuities or consumer products. Greater product complexity is driven by an increased volume and diversity of offerings. Straight-life to variable to second-to-die policies are offered by indirect sales, product seminars, and personal sales calls from anybody who can squeeze a name out of a database.

[4] The "MetLife Retirement IQ Test" was developed by the MetLife Mature Market Institute and in May 2003 surveyed 1,201 men and women between the ages of 55 and 65 who are within five years of retirement.

Take banks as an example, with changes brought about by the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 garners the insurer new access to customers of the banking institution. Even at relatively low penetration rates, a substantial volume of low cost business can be generated by the bank customer list. Furthermore, insurance product complexity makes the sale of insurance products more difficult for new channels, and experience suggests that tenure in product marketing is a strong contributor to success. Product integration is the holy grail of both ‘one stop shopping’ and ‘financial services convergence’. Consumers clearly seek convenience, performance, and trust in their contemporary buying habits. Product proliferation, with or without profit subsidization from one product to another, is unlikely to be a sustainable market strategy. Linking financial services products in a seamless, efficient package, designed for particular market segments and life cycle needs, has great conceptual and ‘street’ appeal. Whether or not the cost of delivering such a program of services, principally driven by the technology requirements, is anybody’s guess.

## 2. Issue of Buyer Competence

### a. Short term memory/judgment

One of the requirements of SB 620, passed in 2003, is that, effective January 1, 2005, agents must satisfactorily complete eight hours of training before selling annuities. This training will cover, among other topics, prohibited sales practices and ways to recognize that a senior may lack the short-term memory and judgment needed to assess a policy or annuity. The brain's ability to learn and remember recent events can change over time due to any number of reasons. Researchers and doctors working with diseases like Bipolar depression and Alzheimer's are finding out that the brain of a disease victim suffers decrements (reductions) in its short-term memory and learning capacities.

Insurance agents are now charged by the legislature to make objective evaluations as to the ability of an individual to contract. Examples of short-term memory capability test indicators include the following;

- Count backwards from 100 by sevens- Thus, 93, 86, 79, 72, 65, … and so on.
- “I am going to say three words- bacon, brown, skillet.” (Any three words will do, but associated words are acceptable.) “We will discuss other matters for a few minutes, then you will need to recite the words back to me.”

These short-term memory test indicators are for illustrative purposes only. Any tests or indicators should be previewed and probably approved by a representative of the insurance company the agent is representing.

### b. California Civil Code §38 & 39

Consider the case where the ‘indicators’ show “…that a prospective insured may lack the short-term memory or judgment to knowingly purchase an insurance product…” What is the agent to do? Someone who completely lacks the powers of understanding is not capable of making a contract, except that the individual is statutorily liable for the value of necessities furnished under a contract. Necessities mean such things as groceries and rent, not insurance. (Cal. Civil Code 38)

Substantial inability may not be proved solely by isolated incidents of negligence or improvidence. (Cal. Civil Code 39)

A senior who may exhibit short-term memory loss would not seem to fall into the *non compos* class. However, an insurance contract made by a person of unsound mind before a judicial determination of incapacity has been determined, is subject to rescission. Bolstering the case for such a rescission would be proof that a person is substantially unable to manage their financial affairs or resist fraud or undue influence. A person lacking sufficient mental capacity to enter into a contract is not held competent even if he has not been judged insane by a court. He or she is one who is unable to understand the effect and nature of their act in making the agreement. An insane person's voidable contract can be ratified or disaffirmed when he or she is again sane, or by the guardian during insanity or his or her representative after death.

## Unique Ethics and Compliance Issues

Complexity and competence issues as discussed above put the agent in an evaluation/judgment quandary requiring the skills of King Solomon. Is this product too complex for understanding? Is a particular senior citizen lacking the memory skills to comprehend what is being presented? The way to avoid problems in this area is to employ safeguards ethical safeguards:

- **Document client files-** A properly documented file contains complete and accurate accounts of client-agent interaction. This allows the agent to properly account for the need for insurance and substantiates the reason for the sale.
- **Change can cause problems-** With any new product or change in law, seek professional legal opinions as to proper procedure. Insurance providers will no doubt have promulgated procedures they feel are appropriate in dealing with seniors when selling a particular product.
- **Service is essential-** Transparency and self-policing, honesty and forthrightness are items hard to quantify, but an agent who maintains a checklist of integrity will seldom have to regret any action he or she has taken.

## Example B

### From the AARP *Bulletin*- Insurance Agent Fraud on the Rise

By Carole Fleck November 2003

Two years ago, at the age of 90, Thomas Pickering of Jacksonville, Fla., was doing the twist. But it wasn't the Chubby Checker variety. At the behest of his trusted insurance agent, Pickering was buying and selling one annuity after another in a deceitful industry practice called "twisting." That's when dishonest agents persuade clients to cash in one investment for another—against their clients' best interests and for the agents' own financial gain.

In Pickering's case, he followed his agent's advice, sold investments before they matured and lost $11,000 in forfeited interest and penalties. He was about to lose another $35,000 cashing in one annuity to buy another—netting his agent $20,000 in commissions—when the company holding the annuity intervened. It suspected Pickering was getting ripped off and called the authorities.

An investigation led Florida's Department of Financial Services (DFS) to revoke agent Peter Waldon's license for fraud. State insurance regulators say agent fraud is on the rise in states like Florida, Texas and California as unsuspecting consumers fall victim to a host of ploys that go beyond "twisting." Barry Lanier of Florida's DFS says he's fielding more complaints about greedy agents earning whopping commissions upfront by pitching unsuitable investments like annuities to older people. But Lanier and other experts say some annuities are not considered to be wise investments for most older Americans because they're based on life expectancy, "so when they're sold to people in their 80s or 90s, it may not be suitable." Growing concern over the sale of annuities to older people prompted the National Association of Insurance Commissioners (NAIC) to adopt regulations that assure that the annuities are suitable to the buyer's needs. "This will place responsibility with companies and agents to assure that fraud doesn't happen," Merwin Stewart, chairman of the NAIC Life Insurance and Annuities Committee, told the AARP Bulletin.

# III Sales Practices for California Agents

## A. Appropriate Advertising

### 1. Advertising for Persons 65 Years and Older

Advertisement or other device designed to produce leads based on a response from a potential insured which is directed at people age 65 or older is must display and disclose in a prominent manner that an agent may contact the applicant if such is the case. Additionally, an agent who makes contact with a prospective insured as a result of acquiring that person's name from a lead generating device needs to make this fact known to the prospective in the initial contact with the person. Insurance companies and their representatives in California must not solicit anyone age 65 and older for the purchase of disability insurance, life insurance, or annuities through the use of a true or fictitious name which is deceptive or misleading with regard to the status, character, or proprietary or representative capacity of the entity or person, or to the true purpose of the advertisement. (Sec. 787)

#### a. Definition of advertisement

The term ‘advertising’ for the purpose of this discussion of the California Insurance Code includes envelopes, stationery, business cards, or other materials designed to describe and encourage the purchase of a policy or certificate of disability insurance, life insurance, or an annuity.

No advertisement can employ words, letters, initials, symbols, or other devices that are so similar to those used by governmental agencies, a nonprofit or charitable institution, senior organization, or other insurer that they could have the capacity or tendency to mislead the public. Examples of misleading materials, include, but are not limited to, those which imply any of the following:

- The advertised coverages are somehow provided by or are endorsed by any governmental agencies, nonprofit or charitable institution or senior organizations.
- The advertiser is the same as, is connected with, or is endorsed by governmental agencies, nonprofit or charitable institutions or senior organizations.

Advertisements used by agents, producers, brokers, solicitors, or other persons for a policy of an insurer must have the written approval of the insurer before they may be used. These ads must contain the agent’s name, business address, telephone number, and any insurance license number.

Ads used by insurers or their representatives cannot solicit a particular class by stating or implying that the occupational or other status as members of the class entitles them to reduced rates on a group or other basis when, in fact, the policy or certificate being advertised is sold on an individual basis at regular rates.

#### b. Seminars, Classes, Informational Meetings

Beyond any other prohibition on untrue, deceptive, or misleading advertisements, the following protocol must be followed when soliciting seniors in a group; In advertisements for an event where insurance products will be offered for sale, if the terms "seminar,"

"class," "informational meeting," or some equivalent term is used to characterize the purpose of the public gathering, the words "and insurance sales presentation" must be used immediately following those terms in the same type size and font as those terms. Each person attending a meeting with a senior shall provide the senior with a business card or other written identification stating the person's name, business address, telephone number, and any insurance license number.
(Section 787(k))

**c. Direct Mailers**

If a company or insurance producer uses direct mailings, this is considered to be a device designed to produce leads based on a response from a person. Since respondents may be 65 years of age or older, these mailers must prominently disclose the fact that an agent may contact the senior. (Section 787)

**d. Advertising Proscriptions**

Here is a list of practices in which insurers must not engage when soliciting business;
Advertising may not use the name of a state or political subdivision of a state in a policy name or description.
In the same manner, it is prohibited to use any name, service mark, slogan, symbol, or device in such a way as to imply that the insurance company or its representative is connected with a governmental agency, such as the Social Security Administration.
Advertising may not imply that the reader may lose a right, or privilege, or benefits under federal, state, or local law if the prospect fails to respond to the advertisement.
The insurance company or its representative is prohibited from using an address so as to mislead or deceive as to the true identity, location, or licensing status of the insurer, agent, broker, or other entity.
In the trade name of its insurance policy or certificate, insurers cannot use any terminology or words so similar to the name of a governmental agency or governmental program as to have the capacity or the tendency to confuse, deceive, or mislead a prospective purchaser. (Section 787(b))

**e. Other Advertising Issues**

Every licensee must print the license number on advertisements, business cards, insurance price quotations. The number must be in the type the same size as any address, phone or fax number printed on the card. Starting January 1, 2005, licensees must print or show on business cards, written price quotations for insurance products, and print advertisements, distributed in California, the word "Insurance" in type size no smaller than the largest indicated telephone number.

**Persons exempt from licensure-** Licensing requirements and advertising regulations do not apply to any person or entity not required or exempt from having an insurance license such as nonresident agents who represent an insurer as a direct response provider. The requirements do not apply to general advertisements of motor clubs that merely list insurance products as one of several services. However, persons who are classified for licensing purposes as solicitors, working as exclusive employees of motor clubs, shall use organizational licensee numbers. (Section 1725.5(h))

**Fines and Penalties-** Violation of advertising regulations are subject to a fines. The first offense is $200, $500 for the second offense, and $1,000 for subsequent offenses. The penalty shall not exceed one thousand dollars ($1,000) for any one offense. These fines shall be deposited into the Insurance Fund. (Section 1725.5 (d))

## Example C Sales Systems

## Your Picture Here→☐

There follows an example of annuity solicitation materials similar to those for sale online to insurance agents. Several websites package and produce ‘systems’ designed to “help the agent succeed….” Does this type of information help or hurt the annuities industry? You be the judge.

## Example material

✧¤✧¤

With 77% of the nation's wealth in hand, 44 million seniors comprise the best market for your services. These loyal clients need your advice. Once you know how to serve them, your business will be easier and more lucrative. Stop wasting time with baby boomers who have all their cash tied up in their 401(K) plans. Seniors have their money in their control, right now! Don't wait for business; learn how to efficiently attract and serve America's largest and most lucrative market today!

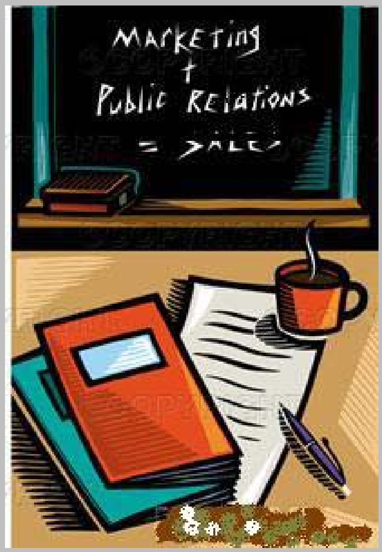
**It's not what you say; it's how you say it.**

- Really Understand Senior Psychology, Serve More People, and Close More Sales
- Create Senior Advertising that Really Works— Get 2% to 4% Responses to Direct Mail and Ample Response to Ads
- Implement Marketing Strategies Tailor-Made for Seniors and Get Responses From Qualified Investors
- Sell in a Way that Inspires Senior Prospects' Confidence to do Business with YOU! Learn the Most Suitable and Appealing Products and Services for This Market and How To Present Them
- Learn to Position Yourself as a Local Senior Financial Expert and have the Newspapers Calling You for Interviews on Senior Financial Issues
- Position Yourself Above Every Other Advisor In Town Attempting to Capture Senior Business

**Annuity Marketing and Annuity Sales**

[Promoted as”foolproof” methods to increase an agent’s annuity sales]

Annuity Direct Marketing Presentation Sales Kit




Annuity Seminar Presentation Sales Materials


**Your Photo Here↑☐**

Annuity Lead Scheme

**↓☐Your Photo Here**


Annuity Newsletter for Prospective Clients

The theory seems to be this-
'Personalizing' with the agent's name and face is proof that the book and agent can be accepted as authority. Kind of a self-generated *nihil obstat quominus imprimatur* (nothing hinders it from being published).

## Other copy accompanying the product pitch goes something like this-

**The Challenge of Annuity Marketing and Annuity Sales**
Other annuity agents, investor inertia to do nothing and increasing regulations make it look like you have a lot of competition. However, if done correctly, annuities are still one of the easiest financial products to sell.

The annuity companies are so product focused that any annuity sales system they provide is focused on the product, not the client. As a result, it appears that people don't want annuities and the sale is hard. Nothing could be less true when you focus your annuity marketing and annuity sales presentation on the person. As an example, how many people do you think want to attend a seminar "How to Save Taxes With Annuities" which is an obvious product pitch**. How many more people want to attend when your seminar is called "Nine Ways to Save Taxes in Retirement."** As soon as you drop your product focus and have your attention on the desires of the prospect, you make more money.

**First, your job is not to tell, educate or explain annuities to seniors.**
In fact, the more you say, the less likely you are to make a sale. If you want to sell anything, your job is to ask questions. If you now spend more than 50% of a prospect interview talking, you must change that by learning how to sell by allowing the prospect to sell themselves. They will do so when you ask the right questions.

Only once the prospect tells you that they need a solution (to cut tax, keep money safe, provide a guaranteed monthly income), do you present any annuity solution or begin talking about products. In fact, you should close the sale (get the prospect's agreement that they need to solve a problem) BEFORE you explain anything about products. Most annuity agents do it the other way round--they explain the product details, going through page after page of the product brochure and then try and close after the prospect's head is filled with confusing new information. This is all because the product companies have you focused on the product, not the person.

Above, you can click on the links which explain systems that will make your life easy and provide you leads from motivated and interested seniors. These annuity marketing systems and annuity lead systems not only fill your pipeline with appointments, you will close more often and faster (no more two hour appointments). We do not market or sell any insurance; we only help you see more people and sell more and faster.

No matter what asset marketing system you use, there is no need to struggle when you can make a sale a day using these proven and guaranteed systems and also have more referrals than you can imagine.

## B. Prohibited Sales Practices

### 1. Selling Annuities for Medi-Cal Eligibility

Annuities cannot be sold to a senior as a means of facilitating eligibility for Medi-Cal. The sale is void if any of the following conditions result from the sale;
The purchaser's assets are less than or equal to the statutorily determined community spouse resource allowance ($92,760 as of 01/01/2004) established annually by the State Department of Health Services.
The purchaser of the annuity would otherwise qualify for Medi-Cal.
The senior's purpose in purchasing the annuity is to affect Medi-Cal eligibility (to become Medi-Cal eligible) and, after the purchase of the annuity, the senior or the senior's spouse does not qualify for Medi-Cal.

If any of the conditions above be true and a fixed annuity is issued to an individual, the issuer shall rescind the contract and refund to the purchaser all premiums, fees, any interest earned under the terms of the contract, and costs paid for the annuity. This remedy shall be in addition to any other remedy that may be available. (Section 789.9)

### 2. In-Home Solicitations

In connection with the activities surrounding the sale of annuities to seniors (this includes sale, offering for sale, or generation of leads for the sale of life insurance, including annuities), Any person who meets with a senior in the senior's home is required to deliver a notice in writing to the senior no less than 24 hours prior to that individual's initial meeting in the senior's home. If the senior has an existing insurance relationship with an agent and requests a meeting with the agent in the senior's home the same day, a notice shall be delivered to the senior prior to the meeting. The notice shall be in substantially the following form, with the appropriate information inserted, in 14-point type:

During this visit or a follow-up visit, you will be given a sales presentation on the following (indicate all that apply):

( ) Life insurance, including annuities
( ) Other insurance products (specify): _________________.

You have the right to have other persons present at the meeting, including family members, financial advisors or attorneys.

You have the right to end the meeting at any time.

You have the right to contact the Department of Insurance for information, or to file a complaint. (The notice shall include the consumer assistance telephone numbers at the department)

The following individuals will be coming to your home: (list all attendees, and insurance license information, if applicable)

____________________ _____________________ _____________________

Upon contacting the senior in the senior's home, the person shall, before making any statement other than a greeting, or asking the senior any other questions, state that the purpose of the contact is to talk about insurance, or to gather information for a follow-up visit to sell insurance, if that is the case, and state all of the following information:
The name and titles of all persons arriving at the senior's home.
The name of the insurer represented by the person, if known.

Each person attending a meeting with a senior shall provide the senior with a business card or other written identification stating the person's name, business address, telephone number, and any insurance license number. The persons attending a meeting with a senior shall end all discussions and leave the home of the senior immediately after being asked to leave by the senior. A person may not solicit a sale or order for the sale of an annuity or life insurance policy at the residence of a senior, in person or by telephone, by using any plan, scheme, or ruse that misrepresents the true status or mission of the contact. (Section 789.10)

## 3. Sharing Commissions with Attorneys

Members of the insurance sales force, be it an agent, broker, or solicitor, who is not an active member of the State Bar of California may not share a commission or other compensation with an active member of the State Bar of California. The phrase "commission or other compensation" should be considered to include pecuniary or nonpecuniary compensation of any kind relating to the sale or renewal of an insurance policy or certificate or an annuity, including, but not limited to, a bonus, gift, prize, award, or finder's fee. (Section 1724)

## 4. Unnecessary Replacement

An act is regarded as a violation of the California Insurance Code if an agent or insurer recommends the replacement or conservation of an existing policy by use of a materially inaccurate presentation or comparison of an existing contract's premiums and benefits or dividends and values, if any, or recommends that an insured 65 years of age or older purchase an unnecessary replacement annuity. In this context "unnecessary replacement" means the sale of an annuity to replace an existing annuity that requires that the insured will pay a surrender charge for the annuity that is being replaced and that does not confer a substantial financial benefit over the life of the policy to the purchaser so that a reasonable person would believe that the purchase is unnecessary. Patterns of action by policyowners who purchase replacement policies from the same agent after indicating on applications that replacement is not involved, shall constitute a rebuttable presumption of the agent's knowledge that replacement was intended in connection with the sale of those policies, and such patterns of action shall constitute a rebuttable presumption of the agent's intent to violate the unnecessary replacement prohibition. It is acceptable for an agent to use additional material beyond that which is required so long as it is not in violation of any statute or regulation. (Section 10509.8)

### b. Examples of unnecessary replacement

A replacement annuity contract is one where the purchase results in the lapse, forfeiture, or surrender of part of all of an existing annuity contract or life insurance policy. As discussed in this section, there are regulations that require certain procedures to be followed before the issuance of a replacement annuity contract.

An example of unnecessary replacement is the unnecessary replacement of an older policy and using its cash value to pay for a brand new policy. An insurer may try to push the sales force to sell more of the company's proprietary products. While management is not saying, "switch," they’re not saying "don't switch." Agents may be subjected to sales meetings given by insurers or wholesalers and strongly encouraged to move policies that are part of ‘the system.’ If business is slow, it may be hard for agents to overlook who is paying the biggest commissions or can promise entrée to more business.

The personal finance sector is constantly changing, and consumers are regularly approached and urged to re-assess their investment and insurance portfolios. This regularly results in changes to the existing portfolios being proposed and often the consumer does not know whether a change is really beneficial or not. Sometimes a new product tends to look as if it is more beneficial at first sight. For example, a replacement policy may offer a tempting short-term teaser rate, but contain restrictive withdrawal and surrender features. It is always advisable to contact the insurer or intermediary from whom the original product was obtained and check whether the new product is in reality more beneficial. In terms of policyholder protection, the insured should consider details of any commission earned by the person selling the policy. Where a senior is being advised to replace an annuity policy, it is important to think about the details of any commission paid by the insurer, as well as any up-front or ongoing fees which the agent earns from the new product provider.

## 5. Bait and Switch

### a. Pretext Interview Definition and Example

#### i. Classic Trust Mill: Alliance for Mature Americans

One of the continuing efforts of the Estate Planning, Trust and Probate Section of the State Bar of California has been its truth squad subcommittee. Its purpose is to investigate and alert the public to the dangers of so-called trust mills that use the popularity of living trusts as a sales device for potentially nefarious purposes. For a number of years, the truth squad has been gathering examples of how some estate-planning businesses use deceptive advertising, scare tactics and attacks on the legal profession to gather clientele and sell often poorly drafted, unnecessary and overpriced estate planning documents to a largely elderly population. Usually, the suspected trust mill has engaged in the unauthorized practice of law; however, in most cases, district attorneys are unable to devote scarce resources to its prosecution. If an attorney is involved, the State Bar has brought disciplinary charges in egregious cases. The attorneys have usually been relatively new admittees who were paid to review trusts drafted by a nonlawyer.

The truth squad was not formed to investigate attorneys specializing in low-cost, high-volume production of estate planning documents where the firm has an attorney-client relationship with the testator. Instead, the squad has been focusing its attention on those organizations that employ unlicensed persons and use high-pressure sales tactics to encourage people to enter into trusts whether or not it is a legally wise method of estate planning. In those cases, documents are generally preprinted forms that may or may not fit the testator's desires, are drafted by nonattorneys and may be reviewed by a mill-employed attorney who never communicates with the client. According to the truth squad, it uncovered one instance where the attorney was reviewing approximately 200 trusts per week at the rate of $ 40 per trust. A related practice employed at some trust mills involves attaching other more lucrative products to the sale of a living trust. For example, sellers of trusts want to convince an elderly person with a modest liquid estate of $100,000 to form a trust.

The seller says the trust will prevent the state from taking over a testator's assets at death, having the assets tied up in court for years and having the person's estate open to the public and subject to potential claims of unknown parties. For approximately $1,500, a certified trust specialist (meaning a nonattorney) will create a trust document and protect the elderly person's estate from all the evils of probate. Later, another salesperson will call on the elderly person and tell him that the liquid assets placed in a trust are still not safe since they are in banks that may default. The only solution is to purchase an annuity (from an insurance company for whom the salesperson is an agent). The annuity is backed by billions in assets, says the salesperson, and owned by a top-rated insurer. No one has ever lost a penny owning this company's annuity. In response, the elderly person closes certificate accounts and IRAs and pays the resulting penalties and income taxes. Based on these high-pressure tactics and deceptive claims, the elderly person owns a trust that may not be necessary, may not be drafted properly or may not be fully funded, and has paid substantial sums for an annuity that provides neither additional protection nor income.

In July 1996, the California Attorney General and the California State Bar jointly initiated legal action against Alliance for Mature Americans alleging that sales representatives visited senior citizens in their homes, used scare tactics to close the deal on a living trust, and then passed along confidential information to sell annuities. Alliance for Mature Americans sold more than 10,000 living trust packages and more than $200 million in annuities. The average age of an Alliance client was 73, and some suffered from Alzheimer's and Parkinson's disease. In early 1997 the California Attorney General announced that a settlement was reached with Alliance for Mature Americans. As part of that settlement, Alliance agreed to reimburse its clients $1 million in fees to prepare living trusts, to pay a $100,000 civil penalty to the State of California, and to stop selling and preparing living trusts for individuals. Alliance is basically out of the trust business. A settlement was also entered into by the Fidelity and Guaranty Life Insurance Company (F&G Life) for annuities sold through Alliance for Mature Americans. The settlement provides each California senior who purchased the F&G Life annuity 60 days to decide whether to keep the annuity or to cancel it, thereby receiving a full refund of the purchase price with interest and without penalties. F&G Life will also pay $150,000 to the State Bar of California to be used to educate senior citizens on estate planning matters and to protect them from estate planning abuses.

### ii. Living Trust Mills and Pretext Interviews

See **Example D** at the end of this section for this information.

### b. Long-Term Care Sales

Long-term care insurance and annuity sales can be tied together in the senior market. Addressing health care issues (long-term care) and financial issues (annuities) are different sides of the same coin. Seniors can perceive annuities as a funding source of long-term care. Agents should be aware of the ‘bait and switch’ issue arising from long-term care sales. There is a belief that agents will sell insurance to those who need the coverage and those who can afford it without distinguishing between the two. A salesman has a commission incentive to sell a long-term care policy, so their claim that a person must have the coverage may not be accurate and promised benefits may not be exactly as explained. Long-term care insurance premiums are variable and since this type of coverage is relatively new, there is not much to go on as far as experience rating is concerned. Policies are priced largely based on the age at which a policyholder first buys coverage. If policyholders face an unanticipated, major rate increase 10 years later, they have few options to change plans or insurers without paying even higher rates because of their increased ages. The competitive market system encourages insurers to price a product cheaply at the beginning and then raise premiums rapidly as policyholders’ age and file claims. These practices result in forced lapses and sour policyholders, their families and friends on the product itself.

Companies promising lower premiums may be offering them because obscure policy provisions may not be favorable, or it is a bait-and-switch gambit where the premiums will almost certainly be raised. These bait-and-switch tactics entice consumers with prices the providers know will be raised in the future. As estimated payouts change and rates increase, however, companies face no disincentives for their mistaken projections. The public should avoid the companies that have large increases in premiums in the past. Insurance commissioners across the country are being granted the legislative authority to ban the sale of a company’s policies for a several years if it persistently files new policies that have inadequate initial rates and are inherently are ‘bait and switch’ offerings.

Consumers should do their homework and buy a policy only from an established company in excellent financial condition. Financially sound industry leaders are likely to maintain premiums. Such insurers do not want to attract negative attention in the media nor do they want to trigger adverse legislation. Farsighted companies that will be around tomorrow cannot afford to be too aggressive in raising rates, so it's likely that the initial premium will remain fixed. Policyholders may pay a little more initially for the coverage, but they are protected against “rate shock” in later years when their incomes are at best static and likely declining.

### c. Unauthorized Practice of Law

**Example D** at the end of this Section has further information on this topic. Drafting, delivering, and interpreting legal documents <u>for compensation or pay</u> are all forms of practicing law. No person shall practice law in California unless the person is an active member of the State Bar. (Business and Professions Code 6125)

## 6. Cause for Suspension

Any of the following acts committed by an agent constitutes cause to suspend or revoke his or her insurance license-
The licensee has induced a client, whether directly or indirectly, to cosign or make a loan, make an investment, make a gift, including a testamentary gift, or provide any future benefit through a right of survivorship to the licensee, or to any of the persons who hold a relationship to the licensee as listed below.
The licensee has induced a client, whether directly or indirectly, to make the licensee or any related person a beneficiary under the terms of any intervivos or testamentary trust or the owner or beneficiary of a life insurance policy or an annuity policy.
The licensee has induced a client, whether directly or indirectly, to make the licensee, or a person who is registered as a domestic partner of the licensee, or is related to the licensee by birth, marriage, or adoption, a trustee under the terms of any intervivos or testamentary trust. However, if the licensee is also licensed as an attorney in any state, the licensee may be made a trustee under the terms of any intervivos or testamentary trust, provided that the licensee is not a seller of insurance to the trustor of the trust.
The licensee, who has a power of attorney for a client has sold to the client or has used the power of attorney to purchase an insurance product on behalf of the client for which the licensee has received a commission.

**Related parties-** This refers to-
A person who is related to the licensee by birth, marriage, or adoption.
A person who is a friend or business acquaintance of the licensee.
A person who is registered as a domestic partner of the licensee.

**Exception-** This section does not apply to situations in which the <u>client</u> is a person related to the licensee by birth, marriage, or adoption or who is registered as a domestic partner of the licensee. (SB 618 and Section 1668.1)

## 7. Penalties

Here is a listing of penalties for insurance licensees in California who want to violate or circumvent proper sales practices.

An insurer or agent must not misrepresent the terms of a policy issued by the insurer or promised to be issued, the benefits or privileges agreed to in the policy, or the future dividends payable under the policy. Insurers or their representatives shall not make any misrepresentation as an inducement to purchase a policy. Agents must not use falsehood or misrepresentation to persuade a policyholder to lapse, forfeit or surrender his or her insurance. Conversely, insurers and their agents may not use any representation or comparison of insurers or policies to an insured which is misleading, for the purpose of inducing or tending to induce him to lapse, forfeit, change or surrender his insurance, whether on a temporary or permanent plan.

Any person violating the provisions of Sections 780 or 781 is guilty of a misdemeanor and punishable by a fine not exceeding one thousand five hundred dollars ($1,500) or by imprisonment not exceeding six months. (Section 780, 781, 782)

Purchasers of insurance in California over age 65 have the right to an examination period of 30 days after receipt of the policy. During that time, if the applicant returns the contract, the policy is void and premiums paid are to be fully refunded within 30 days of notice. If the insurer fails to refund all of the premiums paid in a timely manner (30 days), then the applicant shall receive interest on the paid premium at the legal rate of interest on judgments as statutorily provided. The interest shall be paid from the date the insurer received the returned policy or certificate.

Each policy or certificate shall have a notice prominently printed in NO LESS THAN 10-POINT UPPERCASE TYPE, on the cover page of the policy or certificate and the outline of coverage, stating that the applicant has the right to return the policy or certificate within 30 days after its receipt via regular mail, and to have the full premium refunded. (Section 786)

Persons engaged in transactions of insurance, other than an insurer, who violate the rules regarding sales practices for agents are liable for an administrative penalty-
For the first violation, it is no less than one thousand dollars ($1,000).
A second or subsequent time an agent commits a knowing violation of this article, he or she is liable for an administrative penalty of no less than five thousand dollars ($5,000) and no more than fifty thousand dollars ($50,000) for each violation.

If an action is brought against a licensee as in the previous paragraph and it is determined that the licensee may reasonably be expected to cause significant harm to seniors, the commissioner may suspend his or her license pending the outcome of a hearing made available to the licensee.

Insurers who violate this articles relating to sales practices are liable for an administrative penalty as follows-
Ten thousand dollars ($10,000) for the first violation.
Insurers who violate this article with a frequency as to indicate a general business practice or commits a knowing violation of this article, is liable for an administrative penalty of no less than thirty thousand dollars ($30,000) and no more than three hundred thousand dollars ($300,000) for each violation.

The commissioner may require rescission of any contract found to have been marketed, offered, or issued in violation of Insurance Code articles pertaining to good sales practices. (Sections 789.3, 10509.9)

A proceeding that involves allegations of misconduct committed against a person age 65 or over shall be held within 90 days after receipt by the department of the notice of defense, unless the department or the administrative law judge grants a continuance of the hearing. Under certain circumstances, a continuance of the hearing may be granted. After a duly conducted hearing, the commissioner may suspend or revoke the license of any person or entity that is found in violation of the pertinent articles. (Sections 1738.5, 10509.9)

## Example D

## Insurance Commissioner John Garamendi Sues "Living Trust Mill" Operators for More Than $110 Million

**2005 PRESS RELEASE** For Release: February 10, 2005

The defendants allegedly preyed on seniors, selling unneeded living trusts and annuities that bilked them out of hundreds of millions of dollars in retirement funds
SACRAMENTO – Acting to put an end to a massive “living trust mill” targeting vulnerable senior citizens, Insurance Commissioner John Garamendi and Attorney General Bill Lockyer filed a lawsuit Thursday seeking more than $110 million in penalties, restitution and damages from the operators of the scam.

“Using lies, trickery and outright fraud, these defendants took away the hard-earned savings of thousands of seniors who trusted them with nearly everything they had,” said Commissioner Garamendi. “I’ve attacked these types of predators by arresting them, through legislation, and with senior education. Now, I’m taking them to court to hit them where it hurts the most – the bottom line.”

The defendants in the suit include: Family First Advanced Estate Planning and Family First Insurance Services of Woodland Hills; Nick A. Michaels, president of Family First Advanced Estate Planning; John Owen, president of Family First Insurance Services; American Investors Life Insurance of Kansas; Group Legal Services of San Diego; Senior Law Practice Group; and attorney Thomas R. Lee of Woodland Hills.

An investigation by the California Department of Insurance Investigations Division found that the defendants tricked victims into purchasing tens of thousands of living trusts and related services, and mislead them into buying annuities worth hundreds of millions of dollars. The Woodland Hills-based firm had numerous locations, including a call center in Corona, and regional offices in Sacramento, Fremont, Concord, Santa Ana, Irvine, Canoga Park, Rancho Santa Margarita, Santa Maria, Westlake Village, Pleasanton and Bakersfield.

The complaint seeks to prohibit the defendants from continuing the practices and asks for more than $40 million in civil penalties and at least $70 million in consumer restitution and damages. The suit was filed in Los Angeles Superior Court.

Commissioner Garamendi has worked to fight this type of fraud since taking office in 2003. Earlier this month, due to legislation sponsored by the Commissioner, the Department of Insurance began collecting $1 for each life insurance or annuity sold in the state. The proceeds will go to support more enforcement and education on the dangers of insurance fraud involving these products.
The senior-related legislation Commissioner Garamendi has sponsored and helped

pass includes:
Senate Bill 1273 (Scott): Increases jail time to one year and monetary penalties to $25,000, or three times the amount of the loss above $10,000, for “twisting” or “churning” of annuities.
Assembly Bill 2316 (Chan): Establishes the “Life and Annuities Consumer Protection Fund” by assessing up to $1 per each new individual annuity or life insurance product sold in California.
Assembly Bill 2384 (Nakano): Allows the department to penalize insurance companies who don’t pay credit life and disability policy death benefits within 30 days of the date of a death.
Assembly Bill 1600 (Nakano): This bill extends the period of time that life and disability insurers must maintain records relating to the activities of their agents and authorizes the State Insurance Commissioner to collect and report data relating to life and disability insurance. It enables the Commissioner to gather critical information about the life and annuity marketplace, particularly as it relates to senior citizens.
Senate Bill 618 (Scott): Increases the fines for misrepresentation of insurance policies and increases the penalty for violations relating to the senior insurance law.
The Commissioner also strongly supported SB 620 (Scott), a new law which enacts additional restrictions on advertising practices that target senior citizens. It also expands the scope of existing restrictions to life insurance and annuities. The law also prohibits the sale of annuities to seniors in certain circumstances. Commissioner Garamendi is working to strengthen this new law with additional protections.

In the current case, the defendants tricked their victims through a complex business plan that used a multiple step process. They visited seniors under the guise of offering estate planning services. But in reality, according to the complaint, the defendants were using the meetings to gather information about the seniors’ finances and gain their trust and confidence. When life agents would later deliver the estate planning documents, they then used the financial information submitted for the documents to pitch unnecessary annuities.

Life agents would tell the seniors that their existing investments were no good, and then induce the seniors to close out their existing investments and purchase the annuity policies. The seniors would often do so, believing that the life agent had expertise in estate planning and was acting in their best interests. But investigators found that the life agents were really there to sell annuities in order to gain lucrative commissions, regardless of the damaging impact purchasing annuities had on the seniors’ financial situations.

The complaint also alleges that sales representatives never revealed the drawbacks of these products. For instance, many seniors, particularly those with serious health problems, would likely never be able to benefit from the annuities because the period of maturation was so long, in some cases 15 years. Early withdrawal of funds would precipitate heavy financial penalties.

Consumers, who believe they have been victimized by the defendants, or by another living trust mill or annuity fraud, should report it to the Department of Insurance by calling1-800-927-HELP or visiting the web site at www.insurance.ca.gov. They also may file a complaint online at the Attorney General's web site, http://www.ag.ca.gov/consumers/mailform.htm

## Example D (Cont.) An Unholy Alliance: Nonlawyers Who Mass-Market Trusts, and the Lawyers Who Assist Them

(From information made available by the American Bar Association and the state bars of California, Ohio and Texas.)

As the population ages, scam artists are increasingly targeting seniors. Unfortunately, such scams are not hard to find, and some lawyers are aiding them, whether wittingly or unwittingly. In the past several years, the state bar associations have become increasingly active in disciplining lawyers who affiliate with nonlawyers in schemes that "sell" seniors legal products like living trusts and charitable remainder trusts (CRTs). Living trusts and CRTs are legitimate estate-planning tools for some people, and many estate-planning professionals properly refer clients to licensed lawyers to assist clients in utilizing these tools. However, an entire industry has developed in which "estate planning" companies with reliable-sounding names like "Senior Financial Planning Services" or "Secure Benefits Group" use licensed insurance agents (or simply sales persons) to sell trusts to elderly consumers, whether or not the buyers understand or need them. The lawyers affiliated with these companies typically "review" the trusts and get paid a set fee for doing so. Unfortunately, these lawyers rarely provide appropriate legal advice or evaluation of the client's circumstances to determine whether the trusts are appropriate for the client.

### The typical living-trust scam

In living-trust scams, or living-trust mills, as they are often called, the aim is to sell the most living trusts with the least amount of effort. Frequently, the purpose of the living-trust sale is to obtain asset information from the purchaser in order to facilitate sales of other products, such as annuities or long-term-care policies. The estate-planning company, financial planner, or insurance company may identify potential clients through advertising, telemarketing, or word-of-mouth referrals by customers. They frequently hold free seminars aimed at attracting senior citizens, and use this opportunity to collect names of seniors to target. The companies set up initial appointments by telephone. The initial appointments are usually held in the client's home.

The sales agents are carefully trained to sell the trust document, which in some cases also comes with membership in a dubious prepaid legal plan that may actually be nothing more than a lawyer referral service. The agents frequently regale the purchaser with inaccurate and unrepresentative horror stories about the probate process and the salesperson's allegedly traumatic experiences with probating the estate of a relative. The aim is to convince the purchaser that probate will be lengthy and that a significant portion of the estate will be consumed by lawyers. Probate costs and procedures can vary from state to state. The scammers are very successful in tapping into widespread misconceptions about the cost and complexity of probate.

After the agent makes the sale, the agent and purchaser jointly complete a "living trust application" that contains detailed information about the purchaser's assets. In conjunction with the application, the purchaser is often persuaded to sign several releases and waivers (for example, a release permitting the salesperson to share the information collected with an affiliated insurance company). The agent then collects a check for an amount from $900 to $5,000, often based on the determination by the sales agent of how much the purchaser would be willing or able to pay — the sales agent is paid a commission on the sale. The check is usually made payable to the estate-planning company, although in some cases a second check is written to the lawyer who will "prepare" the trust.

The estate-planning company then fills in the blanks with the information gathered from the client on a trust template and, if a lawyer is involved in the trust mill, the document may then be sent to the lawyer "for review." When the lawyer completes his "review," the document is typically returned to the estate-planning company for insertion in a professional-looking binder of documents containing the living trust, pour-over will, and durable power of attorney. Unfortunately, since the legal documents are based on templates, they are a one-size-fits-all product, and will not necessarily bring about the client's desired result. The document binder is then delivered to the client by an insurance agent affiliated with the estate-planning company, who is also a certified notary.

The client is often unfamiliar with the lawyer involved until this delivery visit — among the documents usually delivered by the insurance agent is a letter or acknowledgement from the lawyer congratulating the client on the purchase of the trust and, in some cases, disclaiming liability for any claims against the lawyer for an invalid trust, will, or power of attorney. If the lawyer has made an effort to contact the purchaser personally, it is generally through a phone call where the lawyer either congratulates the person on his or her decision to purchase a trust, or simply confirms information from the application provided by the estate-planning sales agent.

The delivery visit presents a gold mine of opportunities for the insurance agent. With a thorough knowledge of the purchaser's assets, and an established relationship with the client, the agent is in a powerful position to suggest alternative investments, such as the insurance company's annuity products. The purchaser is often persuaded to sell existing investments, even if this means incurring significant penalties and taxes, to buy the insurance agent's products. This delivery visit presents another opportunity for the agent to earn commissions.

**The role of the lawyer**

There are a variety of ways that lawyers become involved in living-trust mills. In some instances, the lawyer accepts exclusive referrals from a financial advisor, who obtains the clients and then splits fees with the lawyer. In other instances, lawyers may respond to a classified ad or be approached by a representative of the estate-planning company, who describes the tremendous potential for the lawyer if he or she agrees to be the referral lawyer for that company. The lawyer may be asked to attend a seminar where the estate-planning company makes a slick presentation to prospective clients. The lawyer's attendance at the seminar is designed to demonstrate the company's professionalism to prospective clients, while at the same time demonstrating to the lawyer the opportunity for obtaining new clients.

Once the lawyer is on board with the company, the lawyer is usually told that all he has to do is review the application for appropriateness and make brief contact with the clients in exchange for a share of the total fee. The lawyer's share of the fee may range from $100 to $500. Although this amount may appear fairly modest, the true living-trust mill is a volume business, and the lawyer does a minimal amount of work for the fee. This arrangement can sound very attractive to lawyers who are looking for a steady source of income. The estate-planning company may represent to the lawyer that its business model "is approved by AARP" or "has been reviewed to make sure it does not violate the Rules of Professional Conduct." Of course, a lawyer may not rely on representations made by the estate-planning company and must independently determine whether participation in the business model complies with his or her state’s Rules of Professional Conduct (RPCs).

**Lawyers participating in trust mills can violate numerous Rules of Professional Conduct**

A lawyer who participates in a living-trust mill walks into an ethical minefield. Although it may be tempting for a lawyer to try to rationalize that the particular arrangement proposed by the financial advisor or estate-planning company avoids ethical problems, it is unlikely to be the case.

**Lawyer-client relation-** Whether or not a lawyer-client relationship exists between the estate-planning company and the lawyer (in most cases the relationship is more akin to an ongoing business relationship), the lawyer will more than likely be found to have established a lawyer-client relationship with the trust purchaser. The lawyer is usually identified in the documentation provided to the purchaser as the preparer of the documents, and in some instances, does have a brief telephone conversation or meeting with the client. The lawyer's financial interest in having the estate-planning company obtain and refer clients to him is likely to conflict with his duty to provide independent and disinterested advice to his estate-planning client.

**Unauthorized practice of law-** In affiliating with estate-planning companies owned by nonlawyers who send out salespersons or insurance agents to purchasers' homes to sell living trusts, lawyers may violate proscriptions against aiding nonlawyers in the unauthorized practice of law. Although the trust-mill lawyers and salespersons often contend that the sales/insurance agent is simply gathering information, testimony from the victims of the mills belies that claim. What the agents invariably do in practice is provide self-interested legal advice to convince potential purchasers that the living trust is the best option for their needs.

In a recent case resolved by stipulation to a two-year suspension, lawyer Michael J. Scaringi stipulated to assisting a California estate-planning company, and so-called "paralegals" hired and trained by the estate-planning company, in the unauthorized practice of law. Mr. Scaringi acknowledged that he was aware that neither he nor any other licensed Washington lawyer was present "when the client received advice regarding estate planning from the paralegal, signed the engagement letter, and made the payment for the living trust." [See Order Approving Stipulation to Suspension in In re Michael J. Scaringi, 443/527, June 10, 2003. See also Columbus Bar Ass'n v. Fishman, 781 N.E.2d 204 (Ohio 2002) (one-year suspension imposed on lawyer who participated in living-trust mill; lawyer violated Ohio discipline rule prohibiting aiding unauthorized practice of law by allowing insurance agents to explain legal principles of wills and trusts to clients in a manner that directed the clients to choose the trust option)].

**Lack of diligence and communication-**Lawyers who become involved in living-trust mills are very likely to run afoul of their fundamental duty to represent diligently and communicate with the clients whose living-trust documents the lawyers review and/or prepare. The lawyer's review is usually nothing more than filling in the blanks on preprinted forms, with no or minimal communication with the client. In many cases, the clients already have wills and other estate-planning documents, but the lawyer rarely engages enough with the client to find that out, let alone to make a determination whether replacing the will with a trust is in the best interests of the client. [In re Scaringi, mentioned in the preceding section,(by failing to review necessary documents and consult with his clients regarding estate-planning options, the lawyer violated RPC 1.3 (duty to act with reasonable diligence in representing clients), and RPC 1.4 (duty to explain a matter to the extent reasonably necessary to permit the client to make informed decisions about the representation)).]

Multiple violations of the duty of diligence can result in serious consequences. Under the American Bar Association Standards for Imposing Lawyer Sanctions that guide bar discipline cases in Washington, disbarment is the presumptive sanction for a lawyer's knowing failure to perform services for a client when that failure causes "serious or potentially serious injury." Disbarment is also the presumptive sanction for a "pattern of neglect" that causes serious or potentially serious injury to clients.

**Lawyers who participate in trust mills can violate the Consumer Protection Act-** This act prohibits unfair and deceptive acts or practices in the conduct of trade or commerce. The Consumer Protection Act can be enforced by private individuals, or by the attorney general. In recent years, living-trust marketing firms have come under heavy attack by state attorneys general across the nation. The Consumer Protection Act is generally interpreted to apply to entrepreneurial or commercial aspects of the legal profession. An act or practice is considered deceptive if it has a tendency or capacity to deceive a substantial portion of the general public. A lawyer may violate the Consumer Protection Act by assisting sales people in making misrepresentations in the advertising or sale of trust documents. For example, if a lawyer prepares literature that misrepresents the probate process in California as unduly costly or burdensome, and that literature has the potential to mislead consumers into purchasing a trust document not suited to that individual, an action may be brought against the lawyer. A lawyer involved with a trust mill may also violate the Consumer Protection Act by misrepresenting his or her involvement and deceiving consumers into believing a lawyer is substantially involved in preparing the trust and providing legal advice on the appropriateness of the trust for that specific consumer.

## C. Importance of Determining Client Suitability

**NAIC Senior Protection in Annuity Transactions Model Act-** During its 2003 fall national meeting, the National Association of Insurance Commissioners (NAIC) adopted a model regulation designed to help protect senior consumers when they purchase or exchange annuity products. The new measure is designed to ensure that the insurance needs and financial objectives of senior consumers (age 65 or older) are appropriately addressed. The Act is intended to provide senior consumers peace of mind that they are well protected when making financial decisions, according to an NAIC press release. The new regulation sets forth standards and procedures for insurers and insurance producers relating to the purchase or exchange of annuity products involving senior consumers as follows:

In recommending to a senior consumer the purchase of an annuity or exchange of an annuity that results in another insurance transaction, the insurance producer, or the insurer where no producer is involved, must have reasonable grounds for believing that the recommendation is suitable for the senior consumer on the basis of the facts disclosed by the senior consumer as to his or her investments and other insurance products and as to his or her financial situation and needs.

Prior to the purchase or exchange of an annuity based on a recommendation, there must be reasonable efforts to obtain information about the senior consumer's financial status, tax status, investment objectives, and other information that could be reasonably considered by the insurance producer or insurer in making recommendations to the senior consumer.

Neither an insurance producer, or an insurer where no producer is involved, will have any obligation to a senior consumer related to any annuity transaction if a consumer refuses to provide relevant information requested by the insurer or insurance producer, decides to enter into an insurance transaction that is not based on a recommendation of the insurer or insurance producer, or fails to provide complete or accurate information.

An insurer or insurance producer's recommendation will be considered reasonable under the circumstances actually known to the insurer or producer at the time of the recommendation.

An insurer must assure that a system to supervise recommendations is in place that is reasonably designed to achieve compliance with the regulation. An insurer may meet its obligations by conducting periodic reviews or by contracting with a third party, such as an independent agency, to maintain the supervisory system and to provide certification to the insurer that the supervision is occurring.

Compliance with the National Association of Securities Dealers Conduct Rules regarding suitability will satisfy the requirements for variable annuities. However, this does not limit the insurance commissioner's ability to enforce the provisions of the new regulation.

Additionally, the model regulation does exempt insurers and insurance producers from recommendations involving direct-response solicitations (where no recommendations are made based on information provided by the consumer pursuant to the regulation), as well as various funded contracts covered under federal law.

## 1. Need for Information Prior to Making Recommendations

It is the duty of agents to reminded potential purchasers that annuities are not suitable for all investors, particularly those who may need cash for short term needs. This is especially true with variable annuities, whose hybridization of both securities and insurance features may be more difficult to understand.

In the largest disciplinary complaint ever filed by the National Association of Securities Dealers (NASD), it was reported on January 15, 2004 that the agency had charged securities broker/dealer Waddell and Reed of Overland Park, Kansas with “selling unsuitable investments to thousands of clients.” The press release indicated that the “firm advised 6,700 clients to switch their variable annuities from one insurer to another in transactions that generated millions of dollars in fees for the firm but did not benefit the clients. Roughly 20% of the exchanges are likely to result in the clients’ losing money, according to the NASD.” Supervisory and suitability charges were also leveled against the firm and two senior executives. Along with the disciplinary announcement mentioned above, the Securities and Exchange Commission and the NASD advise public investors to ask questions before buying variable annuities and life insurance products.

### a. The Consumer’s Financial Status

Questions should be asked by seniors (or on their behalf) before purchasing an annuity. Among the questions:
Might I need this money in the short term?
Do I have enough money now to purchase this product?
What am I paying for each feature?
Are the extra fees worth it for me?
Will I have to take out a home loan to keep up with payments?

Insurance agents using annuities with a client age 65 or older must have reasonable grounds for believing that the annuity is appropriate for the consumer. This is after the representative obtains the necessary client financial information when determining annuity suitability. The rules also say that producers do not have obligations to the client if the senior refuses to provide pertinent information or decides to enter into an insurance transaction that was not recommended by the producer.

Insurers must design compliance standards to ensure that senior clients are getting appropriate advice and that producers are following the rules. Companies are charged with the responsibility to make sure that their agents or producers are getting the right information to serve the consumer well. Insurers have a responsibility to set up guidelines and education and to monitor their insurance producers. It is the responsibility of the agent to verify that all compliance issues, all financial suitability forms promulgated by the insurer for a particular policy or class of policies are presented to the prospective annuity purchaser.

Regulatory turf issues are not ruled out. A spokesperson for the American Council of Life Insurers said that with variable annuities included in the NAIC proposal, there is a potential conflict of the supervisory duties of broker-dealers under the NASD rules. The Senior Protection Annuity Model Act provisions say the supervisory role rests with the insurance company. The NASD requires that broker-dealers supervise its reps that sell insurance with already-created compliance rules. It is not clear how the two sets of rules would mesh. Nonetheless, the licensee must the California Insurance Code and pronouncements of the Department of Insurance.

### b. Consumer Tax Status

A primary concern for consumers is determining how much income tax will be owed on payments from the annuity contract. The tax treatment of a distribution depends on if it is received before or after the annuity starting date, and on the amount of the investment. Cash withdrawals from deferred or retirement annuities before age 59½ are generally subject to a 10% penalty tax on the portion included in gross income. Payments received on or after the annuity starting date are treated differently.

**The General Rule-** This is a calculation method prescribed by the IRS. Under the General Rule, an individual determines the tax-free part of each annuity payment based on the ratio of the cost of the contract to the total expected return. Expected return is the total amount the taxpayer and other eligible annuitants can expect to receive under the contract. To figure it, a person must use life expectancy (actuarial) tables prescribed by the IRS. The General Rule must be used if a person receives pension or annuity payments from:
1) A nonqualified plan (such as a private annuity, a purchased commercial annuity, or a nonqualified employee plan), or
2) A qualified plan if the person is age 75 or older on the annuity starting date and his or her annuity payments are guaranteed for at least 5 years.

### c. Consumer Investment Objectives

It is generally considered that the first step in establishing financial goals is to analyze the current financial condition. This can be easily accomplished by examining assets and establishing a budget. Budgeting should also include cash reserves for emergencies and insurance coverage. Once the current financial condition has been evaluated, the second step is to establish broad investment objectives. There are essentially three primary investment goals:
Preservation of principal.
Generation of stable after-tax income.
Appreciation of principal.

**Investment Objectives-** Like so many aspects of life, terms of art can sometimes hinder effective communication. In one allegorical case, the broker testified that he asked his client what his investment objectives were and the client replied, "To Make Money!" This cavalier response sent a message that the client was willing to take big

risks in order to get big gains. The broker noted "speculation" as the client's investment objective, yet the client testified that what he meant was that he wanted his money to grow, but not at the expense of his principal.
"Investment objective" is what is known as a term of art in the securities industry. It does not mean that an investor knows what specific investments he or she wants to make. Nor does it require some abstract or philosophical response. Standard choices when considering investment objectives are:
**Preservation of Principal-** The investor does not want to lose any of the money being invested. Such people are generally more comfortable with conservative, stable investments and are not willing to take any risk of principal (the only risk one might be willing to assume is the amount and certainty of the income or appreciation).
**Stable Income-** The investor wants to generate income from the money being invested and is willing to take some small risk in order to receive increased income.
**Appreciation of Principal-** The investor has more of a long-term investment horizon. He or she may be saving for a future goal and is willing to take some risk (approximately 10% of portfolio is a common rule of thumb) in order to increase the growth potential. Or it could be that diversification to achieve a combination of both income and some capital appreciation is desired. Such individuals are comfortable with moderate risk.
Other investment categories include-
**Aggressive Growth** – Investing in order to maximize returns.
**Speculation** - The investor is willing to lose all or a substantial portion of the money.

The Dilemma
Most customer disputes center on the issue of what were the client's investment objectives. Setting investment objectives can be difficult for several reasons. First, the great majority of investors don't have a clear understanding of what they want to do. And for those who do, they do not clearly express it. Second, insurers or brokerage firms usually only require a few pre-printed boxes of investment objectives (such as those above) be shown on the new account form. These categories may prove to be either too limiting or too susceptible to interpretation. Look at the issue from another perspective; the agent checks all of the boxes for the client's investment objectives, reasoning that the client said he or she wanted to do a little of everything. This defeats the purpose of the information – There is no yardstick or guide to ensure that suitable investments are being made? Arguably, everything is suitable and the agent has carte blanche to recommend anything and everything under the sun to the client.
Individuals must make sure that investment objectives reflect the overall guideline for how he or she wants the investments handled.

**d. Other Information**

Prior to the execution of a purchase or exchange of an annuity resulting from a recommendation, an insurance producer, or an insurer where no producer is involved, shall make reasonable efforts to obtain information concerning such other information used or considered to be reasonable by the insurance producer, or the insurer where no producer is involved, in making recommendations to the senior consumer.

Agents should assist in determining suitability for annuity sales by asking a series of questions, an example of which follows. This should be in printed form, signed or acknowledged by the senior, so that both parties know an effort was made to get everything down in writing.
Age
Tax bracket
Upcoming financial needs (does the senior anticipate withdrawing one third or more of his or her total cash and investments for a major purchase, college tuition, or other major need?)

- The need for income, whether adequate funds for emergency financial needs are available.
- Expected future earnings from employment
- What percentage of monthly income is used to pay installment debts (credit cards, auto loans, etc?)
- What percentage of total income do current investments make?
- The ability and willingness to take risk
- The individual's investment knowledge and prior investing experience

Clear and concise information is essential to clearly spelling out investment objectives.

### 2. Need for Full Contract Disclosure

Any contract that does not provide cash surrender benefits or does not provide death benefits at least equal to the minimum nonforfeiture amount prior to the commencement of any annuity payments shall include a statement in a prominent place in the contract that such benefits are not provided. (Section 10168.7)

### 3. Complete Record Keeping

Documenting the client files involves keeping track of the actions taken in dealing with the policy owner. A properly documented file should contain complete and accurate answers to all pertinent questions. This allows the agent to properly assess the need for insurance and substantiates the reason for the sale. Effective case notes should also be kept in the policy owner's file. These should list the date and time of contact with the policy owner and concise summaries of all interactions. It is also recommended that the agent document the level of service provided to the policy owner.

## D. Identify Required Disclosures

Please refer to Attachment I at the end of this book

## E. Policy Cancellations and Refunds

Purchasers of new policies should be sure to read the new policy carefully, and ask the agent or company for an explanation of anything not understood. A 30-day free look period is required for insurance products sold to individuals 60 years of age or over in

California for the purpose of review of the contract. Return during this "free look" period voids the policy, with premiums fully refundable. Consumers should use the time to make sure the policy offers the expected benefits. The policy should be checked for accuracy and for policy limitations, exclusions, or waiting periods. One of the duties of the insurance producer, the individual interfacing with a prospective insured, to see that the consumer understands the 30-day free look period as described in the subsequent Section III E 1 of this book. (Section 10127.10)

Every policy of individual life insurance and every individual annuity contract delivered or issued to a senior citizen in California on and after July 1, 2004, shall have printed on or attached to it a notice stating that, after receipt of the policy by the owner, the policy may be returned by the owner for cancellation by delivering it or mailing it to the insurer or agent from whom it was purchased. The period of time allowed for return of the policy by the insured shall be clearly stated on the notice and this period shall be not less than 30 days. The insured may return the policy to the insurer by mail or otherwise at any time during the period specified in the notice. During the 30-day cancellation period, the premium for a variable annuity may be invested only in fixed-income investments and money-market funds, unless the investor specifically directs that the premium be invested in the mutual funds underlying the variable annuity contract. Return of the policy within the 30-day cancellation period shall have one of the following effects:

1.) In the case of individual life insurance policies and variable annuity contracts for which the owner has not directed that the premium be invested in the mutual funds underlying the contract during the cancellation period, return of the policy during the cancellation period shall have the effect of voiding the policy from the beginning, and the parties shall be in the same position as if no policy had been issued. All premiums paid and any policy fee paid for the policy shall be refunded by the insurer to the owner within 30 days from the date that the insurer is notified that the owner has canceled the policy. The premium and policy fee shall be refunded by the insurer to the owner within 30 days from the date that the insurer is notified that the owner has canceled the policy.
2.) In the case of a variable annuity for which the owner has directed that the premium be invested in the mutual funds underlying the contract during the 30-day cancellation period, cancellation shall entitle the owner to a refund of the account value. The account value shall be refunded by the insurer to the owner within 30 days from the date that the insurer is notified that the owner has canceled the contract.

For individual annuity policies issued or delivered to senior citizens in this state on or after January 1, 2004. All policies subject to this section that is in effect on January 1, 2003, shall be construed to be in compliance with this section, and any provision in any policy which is in conflict with this section shall be of no force or effect.

Every individual life insurance policy and every individual annuity contract, other than variable contracts and modified guaranteed contracts, subject to this section, that is delivered California shall have the following notice either printed on the cover page or policy jacket in **12-point bold print** with one inch of space on all sides or printed on a sticker that is affixed to the cover page or policy jacket:

"IMPORTANT

YOU HAVE PURCHASED A LIFE INSURANCE POLICY OR ANNUITY CONTRACT. CAREFULLY REVIEW IT FOR LIMITATIONS.

THIS POLICY MAY BE RETURNED WITHIN 30 DAYS FROM THE DATE YOU RECEIVED IT FOR A FULL REFUND BY RETURNING IT TO THE INSURANCE COMPANY OR AGENT WHO SOLD YOU THIS POLICY. AFTER 30 DAYS, CANCELLATION MAY RESULT IN A SUBSTANTIAL PENALTY, KNOWN AS A SURRENDER CHARGE."

The phrase "after 30 days, cancellation may result in a substantial penalty, known as a surrender charge" may be deleted if the policy does not contain those charges or penalties.

Every individual variable annuity contract, variable life insurance contract, or modified guaranteed contract subject to this section, that is delivered or issued for delivery in this state, shall have the following notice either printed on the cover page or policy jacket in **12-point bold print** with one inch of space on all sides or printed on a sticker that is affixed to the cover page or policy jacket:

IMPORTANT

YOU HAVE PURCHASED A VARIABLE ANNUITY CONTRACT (VARIABLE LIFE INSURANCE CONTRACT, OR MODIFIED GUARANTEED CONTRACT). CAREFULLY REVIEW IT FOR LIMITATIONS.

THIS POLICY MAY BE RETURNED WITHIN 30 DAYS FROM THE DATE YOU RECEIVED IT. DURING THAT 30-DAY PERIOD, YOUR MONEY WILL BE PLACED IN A FIXED ACCOUNT OR MONEY-MARKET FUND, UNLESS YOU DIRECT THAT THE PREMIUM BE INVESTED IN A STOCK OR BOND PORTFOLIO UNDERLYING THE CONTRACT DURING THE 30-DAY PERIOD. IF YOU DO NOT DIRECT THAT THE PREMIUM BE INVESTED IN A STOCK OR BOND PORTFOLIO, AND IF YOU RETURN THE POLICY WITHIN THE 30-DAY PERIOD, YOU WILL BE ENTITLED TO A REFUND OF THE PREMIUM AND POLICY FEES. IF YOU DIRECT THAT THE PREMIUM BE INVESTED IN A STOCK OR BOND PORTFOLIO DURING THE 30-DAY PERIOD, AND IF YOU RETURN THE POLICY DURING THAT PERIOD, YOU WILL BE ENTITLED TO A REFUND OF THE POLICY'S ACCOUNT VALUE ON THE DAY THE POLICY IS RECEIVED BY THE INSURANCE COMPANY OR AGENT WHO SOLD YOU THIS POLICY, WHICH COULD BE LESS THAN THE PREMIUM YOU PAID FOR THE POLICY. A RETURN OF THE POLICY AFTER 30 DAYS MAY RESULT IN A SUBSTANTIAL PENALTY, KNOWN AS A SURRENDER CHARGE."

The words "known as a surrender charge" may be deleted if the contract does not contain those charges.

This requirement does not apply to life insurance policies issued in connection with a credit transaction or issued under a contractual policy-change or conversion privilege provision contained in a policy. Additionally, this requirement does not apply to contributory and noncontributory employer group life insurance, contributory and noncontributory employer group annuity contracts, and group term life insurance, unless the following exception applies;

When an insurer, its agent, group master policyowner, or association collects more than one month's premium from a senior citizen at the time of application or at the time of delivery of a group term life insurance policy or certificate, the insurer must provide the senior citizen a prorated refund of the premium if the senior citizen delivers a cancellation request to the insurer during the first 30 days of the policy period.

For purposes of this discussion a senior citizen means an individual who is 60 years of age or older on the date of purchase of the policy. (Section 10127.10)

Every life insurer that uses an agent in a life insurance or annuity sale must require as a part of each completed application for life insurance or annuity, a statement signed by the agent as to whether he or she knows replacement is or may be involved in the transaction. Where a replacement is involved, the insurer must require from the agent with the application for life insurance or annuity:

1.) A list of all of the applicant's existing life insurance or annuity to be replaced, and a copy of the replacement notice provided the applicant pursuant to Section 10509.4 of the Insurance Code (See Section I D of this book). The existing life insurance or annuity shall be identified by name of insurer, insured, and contract number. If the existing insurer has not assigned a number, an alternative identification, such as an application or receipt number shall be listed.
2.) Send to each existing life insurer a written communication advising of the replacement or proposed replacement and the identification information obtained pursuant to this section and a policy summary, contract summary, or ledger statement containing policy data on the proposed life insurance or annuity.

Cost indices and equivalent level annual dividend figures need not be included in the policy summary or ledger statement. This written communication shall be made within three working days of the date the application is received in the replacing insurer's home or regional office, or the date the proposed policy or contract is issued, whichever is sooner.

Every existing life insurer or the insurer's agent that undertakes a conservation shall, within 20 days from the date that the written communication are received by the existing insurer, furnish the policyowner with a policy summary for the existing life insurance or ledger statement containing policy data on the existing policy or annuity. Information relating to premiums, cash values, death benefits, and dividends, if any, shall be computed from the current policy year of the existing life insurance. The policy summary or ledger statement shall include the amount of any outstanding indebtedness, the sum of any dividend accumulations or additions, and may include any other information that is not in violation of any regulation or statute. Cost indices and equivalent level annual dividend figures need not be included. When annuities are involved, the disclosure information shall be that in the contract summary. The replacing insurer may request the existing insurer to furnish it with a copy of the summaries or ledger statement, which shall be within five working days of the receipt of the request.

The replacing insurer shall maintain evidence of the "notice regarding replacement," the policy summary, the contract summary, and any ledger statements used, and a replacement register, cross-indexed by replacing agent and existing insurer to be replaced. The existing insurer shall maintain evidence of policy summaries, contract summaries, or ledger statements used in any conservation. Evidence that all requirements were met shall be maintained for at least three years. The replacing insurer must also provide in its policy or in a separate written notice which is delivered with the policy that the applicant has a right to an unconditional refund of all premiums paid which right may be exercised within a period of 30 days commencing from the date of delivery of the policy. In the case of variable annuity contracts, variable life insurance contracts, and modified guaranteed contracts, return of the contract during the cancellation period shall entitle the owner to a refund of account value and any policy fee paid for the policy. The insurer shall refund the account value and policy fee to the owner within 30 days from the date that the insurer is notified that the owner has canceled the policy. (Section 10509.6)

## 1. Free Look

All disability insurance and life insurance policies and certificates offered for sale to individuals age 65 or older in California shall provide an examination period of 30 days after the receipt of the policy or certificate for purposes of review of the contract, at which time the applicant may return the contract. The return shall void the policy or certificate from the beginning, and the parties shall be in the same position as if no contract had been issued. All premiums paid and any policy or membership fee shall be fully refunded to the applicant by the insurer or entity in a timely manner. For the purposes of this section a timely manner shall be no later than 30 days after the insurer or entity issuing the policy or certificate receives the returned policy or certificate. If the insurer or entity issuing the policy or certificate fails to refund all of the premiums paid, in a timely manner, then the applicant shall receive interest on the paid premium at the legal rate of interest on judgments as statutorily provided. The interest shall be paid from the date the insurer or entity received the returned policy or certificate. Each policy or certificate shall have a notice prominently printed in no less than 10-POINT UPPERCASE TYPE, on the cover page of the policy or certificate and the outline of coverage, stating that the applicant has the right to return the policy or certificate within 30 days after its receipt via regular mail, and to have the full premium refunded.
**Conflict-** If there is a conflict between the free-look procedures just outlined and those found in Section 10127.10 of the Insurance Code, the provisions of Section 10127.10 (found in Section I C of this book) shall prevail. (Section 786)

# Attachment I

## Life Agent Disclosure Requirements

**For Sales to Elders**

### Assembly Bill 2107

Effective July 1, 2001, Chapter 442, Statutes of 2000 (Assembly Bill 2107, Scott), strengthens the Elder Abuse and Dependent Civil Protection Act with respect to selling insurance and financial products to elders and clarifies the definition of financial abuse. (The definition of "elders" is any person residing in this state that is 65 years of age or older.)

At the time of the enactment of this law, a life agent is required to make specified disclosures about the potential consequences of entering into financial transactions related to an elder's potential eligibility for Medi-Cal coverage and prohibits a life agent from negligently misrepresenting a product based on its treatment under Medi-Cal.

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### Required Medi-Cal Disclosure

A life agent who offers for sale or sells any financial product on the basis of its treatment under the Medi-Cal program shall provide, in writing, the following disclosure to the elder or the elder's agent:

**NOTICE REGARDING STANDARDS FOR MEDI-CAL ELIGIBILITY**

If you or your spouse is considering purchasing a financial product based on its treatment under the Medi-Cal program, read this important message! You or your spouse does not have to use up all of your savings before applying for Medi-Cal.

**UNMARRIED RESIDENT**

An unmarried resident may be eligible for Medi-Cal benefits if he or she has less than $2,000 in countable resources. The Medi-Cal recipient is allowed to keep from his or her monthly income a personal allowance of $35 plus the amount of any health insurance premiums paid. The remainder of the monthly income is paid to the nursing facility as a monthly share of cost.

**MARRIED RESIDENT**

COMMUNITY SPOUSE RESOURCE ALLOWANCE: If one spouse lives in a nursing facility, and the other spouse does not live in a facility, the Medi-Cal program will pay some or all of the nursing facility costs as long as the couple together does not have more than $92,760 + $2,000 (for 2004).

MINIMUM MONTHLY MAINTENANCE NEEDS ALLOWANCE: If a spouse is eligible for Medi-Cal payment of nursing facility costs, the spouse living at home is allowed to keep a monthly income of at least his or her individual monthly income or $2319 (for 2004), whichever is greater.

**FAIR HEARINGS AND COURT ORDERS**

Under certain circumstances, an at-home spouse can obtain an order from an administrative law judge or court that will allow the at-home spouse to retain additional resources or income. The order may allow the couple to retain more than $92,760 + $2,000 (for 2004) in countable resources. The order also may allow the at-home spouse to retain more than $2319 (for 2004) in monthly income.

**REAL AND PERSONAL PROPERTY EXEMPTIONS**

Many of your assets may already be exempt. Exempt means that the assets are not counted when determining eligibility for Medi-Cal.

**REAL PROPERTY EXEMPTIONS**

ONE PRINCIPAL RESIDENCE. One property used as a home is exempt. The home will remain exempt in determining eligibility if the applicant intends to return home someday. The home also continues to be exempt if the applicant’s spouse or dependent relative continues to live in it. Money received from the sale of a home can be exempt for up to six months if the money is going to be used for the purchase of another home.

REAL PROPERTY USED IN A BUSINESS OR TRADE. Real estate used in a trade or business is exempt regardless of its equity value and whether it produces income.

**PERSONAL PROPERTY AND OTHER EXEMPT ASSETS**

IRAs, KEOGHs, AND OTHER WORK-RELATED PENSION PLANS. These funds are exempt if the family member whose name it is in does not want Medi-Cal. If held in the name of a person who wants Medi-Cal and payments of principal and interest are being received, the balance is considered unavailable and is not counted. It is not necessary to annuitize, convert to an annuity, or otherwise change the form of the assets in order for them to be unavailable.

**PERSONAL PROPERTY USED IN A TRADE OR BUSINESS**

**ONE MOTOR VEHICLE**

IRREVOCABLE BURIAL TRUSTS OR IRREVOCABLE PREPAID BURIAL CONTRACTS.

THERE MAY BE OTHER ASSETS THAT MAY BE EXEMPT.

This is only a brief description of the Medi-Cal eligibility rules, for more detailed information, you should call your county welfare department. Also, you are advised to contact a legal services program for seniors or an attorney that is not connected with the sale of this product.

I have read the above notice and have received a copy.

Dated: ______________________________________________
Signature: ___________________________________________
Signature: ___________________________________________

The statement required in this subdivision shall be printed in at least 12-point type, shall be clearly separate from any other document or writing, and shall be signed by the prospective purchaser and that person's spouse, and legal representative, if any. The State Department of Health Services (http://www.dhs.ca.gov/mcs/default.htm) shall update this form to ensure consistency with state and federal law and make the disclosure available to agents and brokers through its Internet Web site.

## Life Agent's Duties

Pursuant to Section 10193 of the California Insurance Code, with regard to Medicare supplement insurance and long-term care insurance, all insurers, brokers, agents, and others engaged in the business of insurance owe a policyholder or a prospective policyholder a duty of honesty, and a duty of good faith and fair dealing.

Conduct of an insurer, broker, or agent during the offer and sale of a policy previous to the purchase is relevant to any action alleging a breach of the duty of honesty, and a duty of good faith and fair dealing.

## Elder Abuse

Pursuant to Section 15610.30 of the California Welfare & Institutions Code:
(a) "Financial abuse" of an elder or dependent adult occurs when a person or entity does any of the following:

(1) Takes, secretes, appropriates, or retains real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.
(2) Assists in taking, secreting, appropriating, or retaining real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.

(b) A person or entity shall be deemed to have taken, secreted, appropriated, or retained property for a wrongful use if, among other things, the person or entity takes, secretes, appropriates or retains possession of property in bad faith.
(1) A person or entity shall be deemed to have acted in bad faith if the person or entity knew or should have known that the elder or dependent adult had the right to have the property transferred or made readily available to the elder or dependent adult or to his or her representative.
(2) For purposes of this section, a person or entity should have known of a right specified in paragraph (1) if, on the basis of the information received by the person or entity or the person or entity's authorized third party, or both, it is obvious to a reasonable person that the elder or dependent adult has a right specified in paragraph (1).

## Life Agent Financial Products Disclosure

Pursuant to Section 789.8 of the California Insurance Code, if a life agent offers to sell to an elder any life insurance or annuity product, the life agent shall advise an elder or elder's agent in writing that the sale or liquidation of any stock, bond, IRA, certificate of deposit, mutual fund, annuity, or other asset to fund the purchase of this product may have tax consequences, early withdrawal penalties, or other costs or penalties as a result of the sale or liquidation, and that the elder or elder's agent may wish to consult independent legal or financial advice before selling or liquidating any assets and prior to the purchase of any life or annuity products being solicited, offered for sale, or sold. This section does not apply to a credit life insurance product.

A life agent who offers for sale or sells a financial product to an elder on the basis of the product's treatment under the Medi-Cal program may not negligently misrepresent the treatment of any asset under the rules and regulations of the Medi-Cal program, as it pertains to the determination of the elder's eligibility for any program of public assistance.

A life agent who offers for sale or sells any financial product on the basis of its treatment under the Medi-Cal Program shall provide, in writing, the required disclosure.

BILL NUMBER: AB 2107 CHAPTERED
BILL TEXT

CHAPTER 442
FILED WITH SECRETARY OF STATE SEPTEMBER 14, 2000
APPROVED BY GOVERNOR SEPTEMBER 13, 2000
PASSED THE ASSEMBLY AUGUST 29, 2000
PASSED THE SENATE AUGUST 28, 2000
AMENDED IN SENATE AUGUST 24, 2000
AMENDED IN SENATE AUGUST 18, 2000
AMENDED IN SENATE AUGUST 7, 2000
AMENDED IN ASSEMBLY MAY 31, 2000
AMENDED IN ASSEMBLY MAY 16, 2000
AMENDED IN ASSEMBLY APRIL 24, 2000
AMENDED IN ASSEMBLY APRIL 3, 2000
INTRODUCED BY Assembly Member Scott
(Coauthor: Assembly Member Jackson)

FEBRUARY 22, 2000

An act to add Section 6177 to the Business and Professions Code, and to amend and renumber Section 10193 of, to amend Section 10234.8 of, and to add Section 789.8 to, the Insurance Code, and to amend Section 15610.30 of the Welfare and Institutions Code, relating to elder abuse.

LEGISLATIVE COUNSEL'S DIGEST

AB 2107, Scott. Elder abuse.

(1) Existing law imposes on all insurers, brokers, agents, and others engaged in the business of Medicare supplemental insurance and long-term care insurance with a policyholder, a duty of honesty, good faith, and fair dealing.

This bill would impose the duty of honesty, good faith, and fair dealing on insurers, brokers, agents, and others engaged in the business of Medicare supplemental insurance and long-term care insurance with respect to prospective policyholders.

The bill would only permit life agents, on or after July 1, 2001, to sell or offer for sale to an elder or his or her agent any financial product on the basis of the product's treatment under Medi-Cal after providing the elder or his or her agent with a specified disclosure, in writing, explaining the resource and income requirements of the Medi-Cal program, including, but not limited to, certain exempt resources, certain protections against spousal impoverishment, and certain circumstances under which an interest in a home may be transferred without affecting Medi-Cal eligibility.

The bill would exclude from the application of these disclosure provisions credit life insurance, as defined.

(2) Existing law prohibits conflicts of interest between an attorney and client. This bill would require the State Bar to make a report, by December 31 of each year, to the Legislature on the provision of financial services by lawyers to elders, as specified. The report would include the number of complaints filed and investigations initiated, the type of charges made, and the number and nature of disciplinary actions taken by the State Bar.

(3) Existing law defines financial abuse for the purpose of reporting and investigating elder and dependent adult abuse. This bill would revise that definition.

THE PEOPLE OF THE STATE OF CALIFORNIA DO ENACT AS FOLLOWS:

SECTION 1. Section 6177 is added to the Business and Professions Code, to read:

6177. The State Bar by December 31 of each year shall report to the Legislature on the number of complaints filed against California attorneys alleging a violation of this article. The report shall also include the type of charges made in each complaint, the number of resulting investigations initiated, and the number and nature of any disciplinary actions taken by the State Bar for violations of this article.

SEC. 2. Section 789.8 is added to the Insurance Code, to read:

789.8. (a) "Elder" for purposes of this section means any person residing in this state, 65 years of age or older.

(b) If a life agent offers to sell to an elder any life insurance or annuity product, the life agent shall advise an elder or elder's agent in writing that the sale or liquidation of any stock, bond, IRA, certificate of deposit, mutual fund, annuity, or other asset to fund the purchase of this product may have tax consequences, early withdrawal penalties, or other costs or penalties as a result of the sale or liquidation, and that the elder or elder's agent may wish to consult independent legal or financial advice before selling or liquidating any assets and prior to the purchase of any life or annuity products being solicited, offered for sale, or sold. This section does not apply to a credit life insurance product as defined in Section 779.2.

(c) A life agent who offers for sale or sells a financial product to an elder on the basis of the product's treatment under the Medi-Cal program may not negligently misrepresent the treatment of any asset under the statutes and rules and regulations of the Medi-Cal program, as it pertains to the determination of the elder's eligibility for any program of public assistance.

(d) A life agent who offers for sale or sells any financial product on the basis of its treatment under the Medi-Cal program shall provide, in writing, the following disclosure to the elder or the elder's agent:

"NOTICE REGARDING STANDARDS FOR MEDI-CAL ELIGIBILITY

If you or your spouse is considering purchasing a financial product based on its treatment under the Medi-Cal program, read this important message!

You or your spouse does not have to use up all of your savings before applying for Medi-Cal.

UNMARRIED RESIDENT

An unmarried resident may be eligible for Medi-Cal benefits if he or she has less than (insert amount of individual's resource allowance) in countable resources.

The Medi-Cal recipient is allowed to keep from his or her monthly income a personal allowance of (insert amount of personal needs allowance) plus the amount of any health insurance premiums paid. The remainder of the monthly income is paid to the nursing facility as a monthly share of cost.

MARRIED RESIDENT

COMMUNITY SPOUSE RESOURCE ALLOWANCE: If one spouse lives in a nursing facility, and the other spouse does not live in a facility, the Medi-Cal program will pay some or all of the nursing facility costs as long as the couple together does not have more than (insert amount of community countable assets).

MINIMUM MONTHLY MAINTENANCE NEEDS ALLOWANCE: If a spouse is eligible for Medi-Cal payment of nursing facility costs, the spouse living at home is allowed to keep a monthly income of at least his or her individual monthly income or (insert amount of the minimum monthly maintenance needs allowance), whichever is greater.

FAIR HEARINGS AND COURT ORDERS

Under certain circumstances, an at-home spouse can obtain an order from an administrative law judge or court that will allow the at-home spouse to retain additional resources or income. The order may allow the couple to retain more than (insert amount of community spouse resource allowance plus individual's resource allowance) in countable resources. The order also may allow the at-home spouse to retain more than (insert amount of the monthly maintenance need allowance) in monthly income.

REAL AND PERSONAL PROPERTY EXEMPTIONS
Many of your assets may already be exempt. Exempt means that the assets are not counted when determining eligibility for Medi-Cal.

REAL PROPERTY EXEMPTIONS

ONE PRINCIPAL RESIDENCE. One property used as a home is exempt. The home will remain exempt in determining eligibility if the applicant intends to return home someday.

The home also continues to be exempt if the applicant's spouse or dependent relative continues to live in it.

Money received from the sale of a home can be exempt for up to six months if the money is going to be used for the purchase of another home.

REAL PROPERTY USED IN A BUSINESS OR TRADE. Real estate used in a trade or business is exempt regardless of its equity value and whether it produces income.

PERSONAL PROPERTY AND OTHER EXEMPT ASSETS

IRAs, KEOGHs, AND OTHER WORK-RELATED PENSION PLANS. These funds are exempt if the family member whose name it is in does not want Medi-Cal. If held in the name of a person who wants Medi-Cal and payments of principal and interest are being received, the balance is considered unavailable and is not counted. It is not necessary to annuitize, convert to an annuity, or otherwise change the form of the assets in order for them to be unavailable.

PERSONAL PROPERTY USED IN A TRADE OR BUSINESS.

ONE MOTOR VEHICLE.

IRREVOCABLE BURIAL TRUSTS OR IRREVOCABLE PREPAID BURIAL CONTRACTS.

THERE MAY BE OTHER ASSETS THAT MAY BE EXEMPT.

This is only a brief description of the Medi-Cal eligibility rules, for more detailed information, you should call your county welfare department. Also, you are advised to contact a legal services program for seniors or an attorney that is not connected with the sale of this product.

I have read the above notice and have received a copy. Dated:
________________ Signature: _________________"

The statement required in this subdivision shall be printed in at least 12-point type, shall be clearly separate from any other document or writing, and shall be signed by the prospective purchaser and that person's spouse, and legal representative, if any.

(e) The State Department of Health Services shall update this form to ensure consistency with state and federal law and make the disclosure available to agents and brokers through its Internet website.

(f) Nothing in this section allows or is intended to allow the unlawful practice of law.

(g) Subdivisions (b) and (d) shall become operative on July 1, 2001.

SEC. 3. Section 10193 of the Insurance Code is amended and renumbered to read:

10192.55. (a) With regard to Medicare supplement insurance, all insurers, brokers, agents, and others engaged in the business of insurance owe a policyholder or a prospective policyholder a duty of honesty, and a duty of good faith and fair dealing.

(b) Conduct of an insurer, broker, or agent during the offer and sale of a policy previous to the purchase is relevant to any action alleging a breach of the duty of honesty, and a duty of good faith and fair dealing.

SEC. 4. Section 10234.8 of the Insurance Code is amended to read:

10234.8. (a) With regard to long-term care insurance, all insurers, brokers, agents, and others engaged in the business of insurance owe a policyholder or a prospective policyholder a duty of honesty, and a duty of good faith and fair dealing.

(b) Conduct of an insurer, broker, or agent during the offer and sale of a policy previous to the purchase is relevant to any action alleging a breach of the duty of honesty, and a duty of good faith and fair dealing.

SEC. 5. Section 15610.30 of the Welfare and Institutions Code is amended to read:

15610.30. (a) "Financial abuse" of an elder or dependent adult occurs when a person or entity does any of the following:

(1) Takes, secretes, appropriates, or retains real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.
(2) Assists in taking, secreting, appropriating, or retaining real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.

(b) A person or entity shall be deemed to have taken, secreted, appropriated, or retained property for a wrongful use if, among other things, the person or entity takes, secretes, appropriates or retains possession of property in bad faith.

(1) A person or entity shall be deemed to have acted in bad faith if the person or entity knew or should have known that the elder or dependent adult had the right to have the property transferred or made readily available to the elder or dependent adult or to his or her representative.
(2) For purposes of this section, a person or entity should have known of a right specified in paragraph (1) if, on the basis of the information received by the person or entity or the person or entity's authorized third party, or both, it is obvious to a reasonable person that the elder or dependent adult has a right specified in paragraph (1).

(c) For purposes of this section, "representative" means a person or entity that is either of the following:

(1) A conservator, trustee, or other representative of the estate of an elder or dependent adult.

(2) An attorney-in-fact of an elder or dependent adult who acts within the authority of the power of attorney.

(SAMPLE FROM INSURER)

**TITLE: ___________________________**

To: _______________________________________

Prospective California Client *(please print)*

From: ________________________________________
Agent *(please print)*

Pursuant to California Insurance regulation, I am required to advise you of the following:

In the event I recommend that you sell or liquidate any stocks, bonds, IRA, certificate of deposit, mutual fund annuity, or other assets to fund the purchase of an annuity from an insurance company, you may be subject to some or all of the following:

1. Tax consequences;

2. Early withdrawal penalties;

3. Or, other costs or penalties.

You may wish to consult an independent legal or financial advisor before selling or liquidating any assets and prior to purchasing an annuity.
I acknowledge receipt of this disclosure and understand its contents.

________________________________________ _______________
Signature of Prospective California Client Date

________________________________________ _______________
Signature of Agent Date