Guidance on sales of Variable and Index Annuities

The following information is being provided to assist representatives when making recommendation determinations related to variable and index annuity products. The information below should not be viewed as a comprehensive list of considerations; each recommendation is unique and should be made based on individual client needs, objectives, risk tolerance, and individual situations.

Variable Annuities:

Variable annuities are complex products with multiple sub-accounts and varying product features and enhancements. VA appropriateness must be reviewed on a case by case basis since each purchase is unique. VA's, like mutual funds, have different share classes and expense structures that must be considered when making a recommendation. VA's can be either qualified or non-qualified but offer tax deferred withdrawals for non-qualified accounts.

Best Interest Considerations:

- **Liquidity**: VA contracts have limited withdrawal options and are purchased as long term investments, usually for retirement purposes as a supplement to other retirement accounts. VA contracts generally assess penalties if the funds are withdrawn prior to the end of the defined surrender period. Surrender periods vary by product and by share class. It is important to note that VA contracts with greater than a 7-year surrender charge are generally not viewed as suitable by PCS. Products with over 10 years of surrender schedules are prohibited and/or surrender fees of greater than 10% will not be approved. Client liquidity needs must be reviewed as part of the recommendation decision.
- **Concentration**: The contract value at time of purchase must be compared to the client's Liquid Net Worth (LNW) and current income and expense ratio in order to determine if the product purchase may result in the client's inability to meet potential future financial needs. Purchases that result in concentration levels above 50% of LNW may be unsuitable and require additional information to determine both affordability and suitability. Annuities with greater than 50% LNW concentration will undergo heightened review by PCS Principal Review prior to approval, requiring additional detailed information on the client's financial position among other considerations.
- **Death Benefit**: VA contracts provide for death benefit payouts which avoid probate and flow directly to the beneficiaries. VA contracts calculate death benefits and accumulated death benefit guarantees differently by contract type. If the VA is being purchased for the death benefit, the review should include a comprehensive review of the DB calculation options and guarantees available within the policy to determine the best option for the client.
- **Internal expenses**: The internal expenses of a VA are charged directly to the policy owner and can have a large effect on the performance of the contract. A review of the expenses, M&E and admin fees must be completed to determine the appropriateness of the sale.
- **Bonus Features**: Some VA contracts will allow for a "bonus" where the value of the annuity is increased at the time of sale. Bonus features are never free to the policy owner, and the costs associated with the bonus must be disclosed to the client prior to the sale. These costs will also affect the performance of the policy.

- **Riders**: VA's may have enhanced features called riders. Riders may be added to a policy to allow for guaranteed withdrawals, income, accumulation, or death benefit. Every rider has a cost to the policy owner and must be disclosed prior to the sale. These costs must also be factored into the determination of an appropriate sale.
- **Replacements/1035 exchanges**: A replacement/1035 exchange is when one issued insurance policy or annuity is replaced with a new policy. Replacement/1035 exchange applications require additional disclosure to the client as well as enhanced review. A replacement/1035 should always benefit the client or place the client in a better position than the replaced policy. Every replacement/1035 application must include a side by side comparison of death benefit, expenses, and riders. The purchase form must also provide reasoning for the replacement/1035 and how the new product benefits the client.

  Surrender charges must also be reviewed in order to determine if the recommendation is appropriate. VA contracts are constantly being enhanced and these enhancements can create conflicts of interest for a representative since you will receive additional compensation for the new sale. This conflict must be mitigated by concentrating solely on the benefits to the client. Surrender charges are key considerations to the recommendation decision as well as review and approval by firm principals. **Recommendations that include surrender charges must evidence how the client will benefit from making the change in investments.**

- **Share Class**: VA contracts may be purchased in multiple share classes. The standard share class is a B Share, but all available share classes should be reviewed to determine the best option for the client. If an annuity is purchased with a share class other than B, the PCS VA Share Class Disclosure form must be completed, with cost comparison provided, and signed by the client prior to the purchase.
- **L-Share VA**: Some VA contracts are offered in a L-share class. The L-share has higher internal expenses than a B-share product and is designed for a shorter time horizon. Due to the shorter investment time horizon, it does not make sense to add a long-term rider.
- **Tax Considerations**: VA policies provide tax deferral benefits to withdrawals as a benefit for purchasing a contract. When a VA is purchased in a qualified account the tax benefit does not apply since the funds are already in a tax deferred status. The purchase must provide additional benefits to the client in order to justify the purchase. Careful consideration must be taken when recommending retirement plan rollovers into VA contracts to ensure that a different product is not more favorable for the client.

Equity Indexed Annuities:

Equity Indexed Annuities are a hybrid of a fixed and variable annuity but have very different features and benefits and perform very differently. An EIA is an annuity product that is tied to the performance of a market index such as the S&P 500. The annuity performance will depend not only on the performance of the applicable index, but also based on the parameters set up by the client when purchasing the annuity. Each EIA will have a stated return cap and will generally also have a guaranteed minimum return rate.

Best Interest Considerations:

While, many of the factors taken into account during the review of VA contracts are the same for EIA contracts, there are some additional considerations to keep in mind.

- **Liquidity**: EIA contracts have limited withdrawal options and are purchased as long term investments, usually for retirement purposes, as a supplement to other retirement accounts. EIA contracts generally have surrender penalties if the funds are withdrawn prior to the end of the surrender period. Surrender periods vary by product and by share class, and there are many contracts available in the market with long surrender periods with high surrender penalties. EIA contracts with greater than a 7-year surrender charge will require additional justification. Products with over 10 years of surrender schedules are prohibited and/or surrender fees of greater than 10% will not be approved. Client liquidity needs must be reviewed as part of the recommendation decision.
- **Earnings cap/limit**: EIA contracts will have a listed earnings cap or limit. This identified the maximum growth limit for the contract, no matter how well the underlying index does. This limit must be in line with the client objectives and desired return on investment to be considered.
- **Participation Rate**: This identifies the level of participation in the growth of the index the contract will credit to the owner. An index may perform higher than the cap rate, but if the participation rate is only 50% then the contract may not achieve the cap rate. The participation rate must be a key part of the determination.
- **Indexing Method**: There are multiple indexing methods that are available, depending on the contract purchased. The indexing method determines how the performance is credited to the contract, for example the method may be an annual reset, biennial, high water mark, point to point, or other method as defined within the contract. The indexing method must also be part of the recommendation decision process.

All of the above items, in addition to the considerations outlined in the VA review section, must be taken into consideration when determining recommendation suitability of an EIA purchase. These are very complex products and the client's understanding and experience with these products must be considered when recommending the sale.