California Insurance Agents’
4-Hour Annuity Training Course

How Fixed, Variable, and Index Annuity
Contract Provisions Affect Consumers

Sandi Kruise Insurance Training
Quality Education for Insurance Professionals

www.kruise.com
1-800-517-7500
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California Department of Insurance Course Goals and Objectives:

Curriculum Objectives – Training Goals

At the conclusion of this four-hour course, the student must:

- Understand the producer’s legal and ethical obligations toward the consumer (and to the insurer and to regulatory authorities) with regard to the suitability of annuity product recommendations;
- Be able to define “suitability;”
- Be able to define the types of information that must be obtained from the consumer in order to make suitable annuity product purchase recommendations;
- Be able to identify the product features and circumstances where an annuity product would be suitable and it would be unsuitable for a consumer;
- Understand the processes in place to audit and supervise producer activities;
- Identify the regulatory requirements that have been enacted to protect the senior consumer during the purchase and exchange of annuity products;
- Identify how violations of suitability standards may be identified; and,
- Know and understand the penalties provided for violations of applicable laws.

These courses should not be used as an opportunity to persuade, indoctrinate or enlighten agents on a particular philosophy, a political or a public policy position. Opinions about state or federal legislation or forecasting the success or failure of legislation should not be included in these courses. Moreover, absolutely no marketing information is allowed in annuity courses.

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Section 1749.8 of the California Insurance Code took effect on January 1, 2005. This law requires that California resident and non-resident life agents who sell annuity products must first complete eight (8) hours of annuity training that is approved by the California Department of Insurance (CDI). In addition, the law also requires life agents who sell annuity products to satisfactorily complete an additional four hours of annuity training every two years prior to their license renewal. For resident agents, this requirement is part of, and not in addition to, their continuing education requirements.

In addition, Assembly Bill (AB) 689 (Chapter 295, Statutes of 2011) Insurance Annuity Transactions became effective January 2, 2012. AB 689 adds Section 10509.915(a) to the California Insurance Code which states that an insurance producer must not solicit the sale of an annuity product unless the insurance producer has adequate knowledge of the product to recommend the annuity and the insurance producer is in compliance with the insurer’s standards for product training. Insurance producers may rely on insurer-provided product-specific training standards and materials to comply with the product-specific training requirement. Please note that AB 689 does not change the annuity training requirements which are stated in Section 1749.8 of the California Insurance Code. The annuity product-specific training is a separate requirement from the eight and four-hour annuity training noted above.
California Annuity 4 Hour CE Course

I. Identify and discuss suitability  

When recommending that individual consumers, including those over the age of 65, purchase or exchange an annuity, the insurance producer (or insurer where no producer is involved), must have reasonable grounds for believing that the recommendation is suitable for the individual consumer on the basis of the facts disclosed by the individual consumer as to his or her investments and other insurance products and as to his or her financial situation, needs, and objective.

SUITABILITY

“Suitability” is defined as a sale or recommendation that “meets the needs and goals of a person based upon reasonable inquiry concerning the person’s insurance objectives, financial situation, age and other relevant information”.

Annuities are available in a variety of shapes and sizes. Immediate, deferred, fixed, indexed, variable, single-premium, flexible premium. By matching a client's needs and resources with these variables, an annuity can be designed to fit almost any situation. To meet the criterion of suitability, the recommendation of a given annuity must be appropriate for any particular client in light of his or her financial objectives, circumstances, and needs. Whether an annuity is suitable for a client depends on a variety of factors, which are often interconnected.

- The agent should have a solid foundation of the issues surrounding annuities in general.
- The agent should understand the provisions, features, and limitations of the annuity they intend to sell.
- The agent should take time to understand the client's unique circumstances including, but not limited to, financial status, tax status and investment objectives.

In general, all annuity purchasers should have a need and desire for long term accumulation and should be able to afford the annuity premium. In addition, the annuity owner should generally not expect to need to withdraw funds from the annuity in the near future. For variable annuities, the purchaser should also have a need and desire for the growth potential offered by securities, and a willingness to accept the risk that accompanies that potential for growth. One of the agent's most important responsibilities is to make sure a potential buyer thoroughly understands the features, benefits and drawbacks of a financial product before he or she commits to its purchase. Financial professionals who sell variable annuities have a duty to advise clients as to whether the product they are trying to sell is suitable to their particular investment needs. For the variable annuity sale, the agent should ensure that the client understands the following:

- Risk to principal
- Fluctuating investment returns
- No guaranteed growth
- Premium payment options or requirements
- Subaccount investment options and the risk they entail
- Asset allocation and diversification
- Reallocation options
- Tax deferral surrender charges (how long they last and how much they are)
- Free withdrawal provisions, if any
- IRS penalties for early withdrawals
- Tax treatment of withdrawals
- Tax treatment of annuitization
- Death benefit guarantee

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Suitability Information

The producer must analyze at least 13 points of suitability information about the purchaser, including:

1. Age
2. Annual income
3. Financial situation and needs, including financial resources used for the funding of the annuity
4. Financial experience
5. Financial objectives
6. Intended use of the annuity
7. Financial time horizon
8. Existing assets, including investment and life insurance holdings
9. Liquidity needs
10. Liquid net worth
11. Risk tolerance
12. Tax status
13. Whether the purchaser has a reverse mortgage

Producer's Belief an Annuity Is Suitable

As a result of the suitability analysis, the producer must have a reasonable basis to believe that all the following points are true before recommending the purchase of an annuity:

1. The consumer has been reasonably informed of the various features of the annuity, such as:
   - Surrender charge period and amounts
   - Potential tax penalties associated with a sale, exchange, surrender or annuitization of the annuity
   - Expenses and investment advisory fees
   - Features of and potential charges for riders
   - Limitations on interest returns
   - Insurance and investment components
   - Market risk

2. The consumer would get a tangible net benefit from the transaction.

3. The annuity as a whole, including any riders or product enhancements, is suitable for the consumer based on his or her suitability information. In the case of an exchange or replacement, the transaction as a whole is suitable.

4. An exchange or replacement (if applicable) is suitable taking into consideration, among other factors, whether the consumer:
   - Will incur a surrender charge or be subject to the start of a new surrender period
   - Will lose existing contractual benefits
   - Will be subject to increased fees, investment advisory fees, or charges for riders and product enhancements
   - Will benefit from product enhancements and improvements
   - Has transacted another annuity exchange or replacement and, in particular, has had one within the preceding 60 months
However, a producer may not recommend to a consumer age 65 or older an annuity replacement that incurs a surrender charge on the replaced policy unless the exchange will result in a substantial benefit over the life of the policy.

The Insurer will review each annuity application for suitability and will not issue an annuity unless they have a reasonable basis to determine that the recommendation is suitable. Annuity sales made in compliance with FINRA suitability requirements and supervised under FINRA rules satisfy the requirements of California's suitability law, provided the suitability analysis includes consideration of the consumer's income and the intended use of the annuity.

Recordkeeping

The producer must, at the time of sale, make a record of any recommendation made to a purchaser. The record must contain the information collected from the consumer and any other information used to make the recommendation. The producer must be able to provide The Insurer or the insurance commissioner with records for five years after the transaction is completed or as long as the annuity is in force, whichever is longer.

Producers may not dissuade consumers from truthfully responding to an insurer's request for confirmation of suitability information, filing a complaint or cooperating with the investigation of a complaint.

Insurer’s Suitability Supervision

Insurers must supervise the suitability of their producers' sales and may not issue an annuity unless there is a reasonable basis to believe it is suitable based on the consumer's suitability information. Insurers must review the suitability of every recommendation, either in-house or by contracting with a third party. Insurers must also maintain procedures to detect — before or after policy issue and delivery — any unsuitable recommendations. This monitoring may include confirmation of consumer suitability information through customer interviews, confirmation letters or other means.

The law requires every insurer to report annually to its senior management on the effectiveness of its suitability supervision system, the exceptions discovered and any corrective action taken.

Penalties

The insurance commissioner may order an insurance company, agency or producer to take corrective action for any consumer harmed by the insurance producer's violation of this law. Penalties are determined by the insurance commissioner under California law. A producer who submits unsuitable annuity recommendations to The Standard is subject to termination of his or her sales appointment.

THE NAIC'S SUITABILITY MODEL

In connection with their increased scrutiny of annuity sales, the National Association of Insurance Commissioners (NAIC) a national association of state insurance regulators, has developed a model regulation that will govern required disclosures in the sale of annuities. The model creates standards for both agents and insurers to be sure that the insurance needs and financial objectives of senior consumers are appropriately addressed whenever the sale of an annuity is recommended to a senior (65 years or older).
Recommendations for Required Disclosures in Annuity Sales

- Identification of the product as an annuity
- Identification of the issuing insurer
- Specific description of when surrender charges apply
- Explanation of how the current interest rate will be credited, the period during which the initial rate applies, the guaranteed minimum rate, and how future interest rates will apply
- Statement regarding availability of a death benefit
- Description of the effect of current tax law on annuity accumulations and withdrawals
- Statement of any other policy charges and fees

Under the **NAIC Senior Protection in Annuity Transactions Model Act and Model Regulation**, a “senior” consumer was defined as a person **sixty-five years of age or older**.

It imposes a suitability standard on insurance producers and insurers that is patterned after NASD Conduct Rule 2310, which requires that agents have reasonable grounds for believing that the recommendation is suitable 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. Insurers are required to either establish and maintain a system to supervise recommendations that is reasonably designed to achieve compliance with the regulation, or contract with a third party, including a general agent or independent agency, to maintain such supervisions with respect to insurance providers under contract with or employed by the third party. Finally, the Model Regulation authorizes the insurance commissioner of a state to order an insurer, insurance producer and/or general or independent agency to take reasonably appropriate corrective action for any senior consumer harmed by the insurer's or insurance producer's violation.

**CRITERIA FOR ASSESSING ANNUITY SUITABILITY WITH SENIORS**

Purchasing an annuity should entail looking at a senior's total financial picture, both today and into the future as well. The NAIC has identified four criteria which should be evaluated prior to making a recommendation.

- **Criteria 1.** The senior's financial status;
- **Criteria 2.** The senior's tax status;
- **Criteria 3.** The senior's investment objectives; and
- **Criteria 4.** Other information which may be a consideration regarding the purchase.

**CONSIDERING FINANCIAL STATUS**

Purchasing an annuity usually means making a long-term commitment; one that carries costs (i.e. surrender charges) if the senior is forced to prematurely surrender the contract for such reasons as a change in financial status. That is why it is so important to take time early on to understand the senior's current financial status and how that may be likely to change during the term of an annuity. It is important to evaluate these considerations from a present and future perspective.

**Income**

Consider the senior's income needs. Many seniors live on a strict budget and rely on multiple sources of income to sustain lifestyle. Agents should verify that seniors have additional resources to supplement **additional income needs in the short-term.**
Liquid Assets

Are the senior’s liquid assets sufficient, and does the amount they intend to invest represent too great a portion of the senior's total liquid assets? Most financial experts agree that seniors should have liquid assets equal to of at least 6 months of living expense.

Is Comprehensive LTC Insurance in Place?

Consider the senior's other financial needs. Does the senior have a complete financial plan, including long-term care insurance for example? Are there other expected short-term financial contingencies - like owing income tax on the sale of a home - that might take priority over the purchase of an annuity?

THE CONSUMER’S TAX STATUS

Annuities provide special tax advantages. Earnings receive the benefit of tax-deferral while they remain in the annuity. And where non-qualified annuities are concerned, the income stream from a settlement option is also tax-advantaged.

*The annuity’s distributed earnings and interest will receive ordinary tax treatment* While annuity funds accumulate tax deferred within the contract, on withdrawal or distribution their earnings are subject to tax as ordinary income, not capital gains. The buyer's tax bracket should be considered, as well as that of the beneficiary who would be responsible for the income tax due on the earnings upon the death of the owner or annuitant. Agents should also consider the senior's tax status before recommending an annuity.

The Senior’s Income Tax Bracket

The senior’s tax bracket is an important consideration to evaluate where withdrawals are anticipated. Many seniors have relatively low income tax brackets. Since gains in non-qualified annuities are withdrawn first, earnings are subject to income tax. Agents need to exercise caution to ensure that structuring withdrawals will not send the senior into a higher tax bracket, or worse yet, trigger the taxation of Social Security benefits. If non-settlement withdrawals are anticipated and the senior is in a high tax bracket, tax-free investments may be more suitable than tax-deferred annuities because they might ultimately leave the senior with more usable dollars.

The Income Tax Bracket of Beneficiaries

A beneficiary pays ordinary income tax on annuity gains. If the beneficiary is a high-income earner, gains (and pre-tax contributions) are taxed at the beneficiary’s income tax rate. If wealth transfer is the sole objective in purchasing an annuity, life insurance is more suitable.

The Tax Consequences of Exchange

In some cases, a senior may wish to liquidate or exchange another investment to purchase an annuity. However, an exchange or liquidation may carry tax consequences and other costs that negate the benefits of the annuity.

Employer-Sponsored Plans

Annuities help Americans supplement retirement savings. Working-aged adults should maximize contributions to employer-sponsored plans before investing in tax-deferred annuities. Most employer-sponsored plans are structured using pre-tax (versus after-tax) dollars. Plus, many of these plans match employees’ contributions.
• **The accumulation must be long term.** With few exceptions, deferred annuities are not suitable for any short-term investment or savings. The surrender charges could extend 7 to 10 years into the contract and the IRS penalty for pre-59½ distributions make a deferred annuity unsuitable for anything other than long-term goals. If the client will need access to the funds before the end of the surrender charge period before the client reaches age 59½, a deferred annuity probably is not suitable.

• **If the annuity is to fund a tax-qualified retirement plan, the buyer's age must be considered.** Generally, minimum distribution tax rules require that withdrawals from traditional IRAs begin when an owner reaches age 70½. If minimum distributions would begin while the annuity is still in its surrender charge period, the buyer would be faced with the unpleasant choice of paying the surrender charge penalty imposed by the insurer or the penalty imposed by the IRS for failing to take the minimum distribution. Though most annuities waive surrender charges for minimum distributions, agents should be aware of this issue and review the contracts they market.

• **Other qualified retirement plan options available to the client** Generally, an individual should be encouraged to take full advantage of any employer-sponsored retirement plan (such as a 401(k) or 403(b) plan) or any tax-deductible IRA contributions he or she could make as a first step to funding retirement. A deferred annuity should complement, not replace, that option. In addition to offering tax deferral, an annuity does not impose contribution maximums, as do qualified plans.

### The 10% Penalty Tax

Annuities were not intended to be short-term tax shelters. A 10% tax applies when withdrawals are made prior to the age of 59½. When working with working-aged adults, annuities may not be suitable if the client anticipates access prior to 59½. While seniors may not be affected by the 10% penalty tax, their beneficiaries may be.

### THE CONSUMER'S INVESTMENT OBJECTIVES

Due to design innovations, annuities can accommodate a broad range of investment objectives. Still, the benefits of an annuity may not always be compatible with the senior's financial objectives.

### The Senior's Risk Tolerance And Return Expectations

With a choice of fixed, equity-indexed and variable annuities, agents can usually help satisfy the senior's risk tolerance and reward expectations. Knowing which type of annuity is most suitable requires a solid understanding of the products themselves. As agents, it is important to help consumers make reasoned and personal decisions when it comes to evaluating which type of annuity is most suitable. Riskier investments usually translate to higher potential for return while conservative investments offer lower reward potential. The same can be said for fixed, equity-indexed and variable annuities. Seniors, in particular, tend to be especially sensitive to this issue since many of them may rely on their annuity for income at some point in the future.

### The Senior's Investment Horizon

It is important that the surrender period of the proposed annuity coincides with the date the senior wants to access or annuitize the funds. Many annuities on the market today have surrender periods of 10 years or more. If the senior anticipates a five-year horizon, a 10-year surrender period may not be suitable due to the surrender charge.
The Senior’s Liquidity Needs

Although most annuities contain some liquidity provisions they are not a major source of liquidity. If the senior needs more than the contract allows, a costly surrender charge applies. In this event, another investment vehicle might be more suitable than an annuity.

The Investment Frequency

If the client wants to make systematic deposits into an annuity, the contract must be structured to accept additional deposits once it has been opened. A flexible premium deferred annuity vs. a single premium deferred annuity would be advisable under these circumstances.

OTHER INFORMATION TO BE USED OR CONSIDERED RELEVANT

Making suitable recommendations requires an educated agent to use their comprehensive product knowledge to match solutions with the needs of their client. The State's new training requirements provide agents with the fundamental knowledge required to help make suitable recommendations. Agents must continually seek additional training in order to stay on top of the many changes in the annuity marketplace. Buyer's guides are available from the NAIC to help consumers make informed decisions. The California Department of Insurance also has a buyers guide on their web site (www.insurance.ca.gov).

The Need for Complete Record Keeping

Documentation

Documentation is important for the client as well as the agent. Agents must consistently document every client transaction. If an agent is accused of an error or an omission consistency will be very important to their defense. Documenting some items and not others, or some clients and not others, can be used to show lack of attention to detail and even discriminatory treatment of one client vs. others. With computers, it has become easier to document everything from incoming and outgoing calls to correspondence. It may be a good idea to not only log in outgoing calls, but attempted calls as well. Time, as well as date and content of the call or correspondence, is important to document.

Sending a recap letter within 24 hours of every client meeting may clear up any potential misunderstanding before it occurs. It concisely reviews the content of the meeting and summarizes the actions the agent will be taking to remind the client of actions they have to fulfill. The process that leads to a product recommendation and purchase should be documented. It should begin with the information gathered in the needs analysis and how that information was used in the product recommendation. The agent should document the how the recommended product meets the client's needs. Supporting documentation should be attached.

The NAIC's Senior Protection in Annuity Transactions Model Regulation contains provisions that will require insurers to establish a system of monitoring suitability recommendations. As more states adopt this new model, greater attention will be directed to record keeping.

Recording Meetings or Presentations

By having an audio or visual record of the meeting, agents eliminate the possibility for misunderstandings. People often hear what they want to hear, and even in the best circumstances we tend to have different recollections of events and meetings. This may be the case when discussing risk and reward, since
sometimes the client only remembers the conversation about potential reward, not the possibility of loss. This type of record may also be helpful in determining a case of intermittent capacity.

An Objective, Third-Party Observer

It may be feasible to include an observer in a meeting with the client's prior permission. This should not be someone working for the agent, or anyone who could possibly be considered partial. The family CPA or attorney may be a good choice. Many times a client may be feeling uncomfortable themselves, even though they are not ready to admit it, and request to bring one of their adult children to a meeting. This can be an ideal situation for the agent since they have the opportunity to become more familiar with the extended family situation.

The Need for Full Contract Disclosure (Section 10168.7 of the CIC)

Annuity products can be complex. The more complicated the product, the greater the chance that a client may not understand it fully. According to California Insurance Code (§785), agents owe a prospective client aged 65 or older a duty of honesty, good faith and fair dealing. The Department Of Insurance wants agents to assist seniors to make informed buying decisions.

To accomplish this, agents have an implied responsibility to provide full disclosure including advantages and disadvantages for the client's situation. Suitability demands that producers recommend only those products with which they are familiar and that they can explain easily. In addition, they should be able to discuss the financial strength and track record of the issuing insurers.

REQUIRED DISCLOSURES (AB 2107, Scott, Chapter 442, Statutes of 2001- Attachment III)

The primary determinant of full disclosure is whether the client has been provided, in an understandable manner, with all of the facts that are material to his or her purchase decision. Regulators say that the three main areas of deficiency in regard to annuity sales disclosure involve the following:

1. Interest rates
2. Surrender charges
3. Tax implications

INTEREST RATES

An annuity is a long-term contract. Clients must understand that interest rates and market conditions change.

SURRENDER CHARGES

Clients must understand the period of time and the conditions under which surrender charges may be assessed as well as any exceptions such as “Free” withdrawals.

TAX IMPLICATIONS

Clients must understand that annuities earn interest on a tax deferred, not a tax-free basis. Taxes are due on annuity accumulations when they are paid out of the contract. Clients must also be aware of the 10% penalty tax to which withdrawals from the contract may be subject if they are made prior to age 59½, unless certain exceptions apply.

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10127.10(c) 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 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 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.

(d) 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.

Policy Cancellation and Refunds (Sections 10127.10 and 10509.6 of the CIC)

Free Look – 60 Years and Older

Senior citizens who purchase annuities must now be given the right to cancel them within 30 days and receive a full refund. This law applies to all contracts sold and delivered after 1/1/04. Return of the policy during the cancellation period has the effect of voiding the policy from the beginning and placing the parties in the same position as if no policy had been issued. That means that all premiums and policy fees must be refunded by the insurer. 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 must receive interest on the paid premium at the legal rate of interest. If a variable annuity is involved, the owner is entitled to a full refund of his account value. And, during the 30-day free look cancellation period the premium must only be invested in fixed income investments.

These new rules are underscored by the need for every policy to print, in 12-point bold, the following disclaimers:

YOU HAVE PURCHASED AN ANNUITY CONTRACT. 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.

For variable annuity contracts, the disclaimer is slightly modified as follows:

THE 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 THE 30-DAYS MAY RESULT IN A SUBSTANTIAL PENALTY, KNOWN AS A SURRENDER CHARGE.

The free look provisions (CIC 786) apply to persons 60 years and older and do not apply to contracts sold through group plans.

Free Look – Under Age 60 Years

Agents should know that clients over age 60, as well as persons younger than 60, who purchase annuities must now be given the right to cancel them within 30 days (786, 10127.9, 10127.10 CIC). This law, which supersedes similar legislation defining seniors as 65 years, applies to all contracts sold and delivered after 1/1/04. Return of the policy during the cancellation period has the effect of voiding the policy from the beginning and placing the parties in the same position as if no policy had been issued. That means that all premiums and policy fees must be refunded by the insurer. 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 must receive interest on the paid premium at the legal rate of interest.

FREE LOOK FOR VARIABLE ANNUITIES (Section 10127.10)

The California Insurance Code also creates new free-look language affecting variable annuities. While the old law provided for a 30-day “free look” period, the new law states that the annuity must be invested in fixed-income accounts during this 30-day period, so that a full refund can be made. By default, all premiums paid for a variable annuity will be allocated to fixed-income investments and money market funds during the free-look. This assures that all premiums paid will be refunded during the free-look period if the senior has a change of mind or circumstances. For this provision, a “senior” is someone age 60 or older. As an exception to this, the investor may direct the premium to be invested into the variable...
annuity’s subaccounts immediately. However, if this is case, the senior is no longer guaranteed a full return of premium.

A. Licensing requirements for life-only agents

Agents must be licensed by the California Department of Insurance as Life Only agents to sell Annuities.

1. Training (section 1749.8 of the CIC)

Life Agents Annuity Training Requirement

- 8-Hour one-time annuities course
- 4-Hour refresher course
- Product-specific training from each insurance company they represent

Senate Bill 620 (Scott, Chapter 547, Statutes of 2003) was signed into law on September 29, 2003. This law requires that effective January 1, 2005, life agents who sell annuity products must satisfactorily complete eight hours of training prior to soliciting individual consumers in order to sell annuities. This law pertains to both California resident and non-resident agents. This training requirement does not apply to nonresident agents representing a direct response provider as defined within Section 1749.8 of the California Insurance Code.

Both classroom and correspondence courses have been approved by the California Department of Insurance (CDI) to meet this requirement.

To verify that agents selling annuities are meeting the training requirement, the CDI will be checking insurer’s records during market conduct reviews. Market conduct reviews may include requests for verification from insurers that their life agents authorized to sell their annuity products completed the annuity training requirement. Legal action may be pursued if agents are found to not be meeting the annuity training requirement.

Senate Bill 620 also requires that effective January 1, 2005, life agents who sell annuity products must satisfactorily complete four hours of training every two years prior to license renewal. For California resident agents, this requirement must be part of, and not in addition to, the continuing education requirements of Section 1749.3 of the California Insurance Code. Life agents are required to complete the 4-hour training course beginning with the license term that follows the license term in which they completed the 8-hour initial training course.

Please contact either the CDI’s Toll-Free Producer Licensing Number at 1-800-967-9331 or the CDI web site at www.insurance.ca.gov should you have any questions concerning the life agent annuity training requirement.

B. Checklist as required by Section 10509.914(e) of the CIC

Required Checklist

10509.914(e) An insurance producer or, where no insurance producer is involved, the responsible insurer representative, must at the time of sale do all of the following:

- Make a record of any recommendation subject to subdivision (a) of this section. (These types of notes should be entered into the client’s file or database and be accessible for reference or review by the State).
• Obtain a customer signed statement **documenting a customer's refusal to provide suitability information**, if any. To limit suitability exposure this statement should disclose to the client that failure to provide the required information may limit the protections offered under the law. Each insurer’s compliance department should be consulted to determine what type of form they will require before making or using any such form.
• Obtain a customer signed statement acknowledging that an **annuity transaction is not recommended** if a customer decides to enter into an annuity transaction that is not based on the insurance producer's or insurer's recommendation.

An agent may be absolved of the suitability requirements if the client refuses to give the agent the required information, the client provides false or incomplete information, or the client chooses to purchase annuities against the recommendation of the agent.

C. Insurer responsibilities as required by Section 10509.914 (f)(D) and (E) of the CIC

**Insurer Responsibilities**

Under 10509.914 of the California Insurance Code, responsibilities also apply to insurers as follows:

An insurer must establish a supervision system that is reasonably designed to achieve the insurer's and its insurance producers' compliance with this article, including, but not limited to, all of the following:

• The insurer must maintain reasonable procedures to inform its insurance producers of the requirements of this article and must incorporate the requirements of this article into relevant insurance producer training manuals.
• The insurer must establish standards for insurance producer product training and must maintain reasonable procedures to require its insurance producers to comply with the requirements of Section 10509.915.
• The insurer must provide product-specific training and training materials which explain all material features of its annuity products to its insurance producers.
• The insurer must maintain procedures for review of each recommendation prior to issuance of an annuity that are designed to ensure that there is a reasonable basis to determine that a recommendation is suitable.
• The review procedures may apply a screening system for the purpose of identifying selected transactions for additional review and may be accomplished electronically or through other means, including, but not limited to, physical review. An electronic or other system may be designed to require additional review only of those transactions identified for additional review by the selection criteria.
• The insurer must maintain reasonable procedures to detect recommendations that are not suitable. This may include, but is not limited to, confirmation of consumer suitability information, systematic customer surveys, interviews, confirmation letters, and programs of internal monitoring. Nothing prevents an insurer from complying by applying sampling procedures or by confirming suitability information after issuance or delivery of the annuity.

**SECTION 10509.914 (2012)** In recommending annuities to individual consumers, including consumers over the age of 65, for purchase or exchange, the **insurance producer (or insurer where no producer is involved) must have reasonable grounds for believing that the recommendation is suitable** for the individual consumer on the basis of the facts disclosed by the individual consumer as to his or her investments and other insurance products and as to his or her financial situation, needs and objectives and reasonable belief of the following:

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

The consumer would receive a tangible net benefit from the transaction.

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

In the case of an exchange or replacement of an annuity, the exchange or replacement is suitable, including taking into consideration all of the following: Whether the consumer will incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits, such as death, living, or other contractual benefits, or be subject to increased fees, investment advisory fees, or charges for riders and similar product enhancements; whether the consumer would benefit from product enhancements and improvements; whether the consumer has had another annuity exchange or replacement and, in particular, an exchange or replacement within the preceding 60 months.

Prior to the execution of a purchase, exchange, or replacement of an annuity resulting from a recommendation, an insurance producer, or an insurer where no producer is involved, must make reasonable efforts to obtain the consumer's suitability information.

Except as permitted under subdivision (d), an insurer must not issue an annuity recommended to a consumer unless there is a reasonable basis to believe the annuity is suitable based on the consumer's suitability information. The preceding sentence and subdivision (d) notwithstanding, neither a producer nor an insurer must in any event recommend to a person 65 years of age or older the sale of an annuity to replace an existing annuity that requires the insured to pay a surrender charge for the annuity that is being replaced, where purchase of the annuity does not confer a substantial financial benefit over the life of the policy to the consumer, so that a reasonable person would believe the purchase is unnecessary.

Section 10509.915(a) CIC (2012) An insurance producer must not solicit the sale of an annuity product unless the insurance producer has adequate knowledge of the product to recommend the annuity and the insurance producer is in compliance with the insurer's standards for product training. Insurance producers may rely on insurer-provided product-specific training standards and materials to comply with the product-specific training requirement.

Section 10509.915(b)(2012) In addition to the above, an insurance producer must complete a one-time eight credit-hour annuity training course by an proved education provider, prior to commencing the transaction of annuities. Further, every producer who engages in this state in the sale of annuity products must satisfactorily complete a four-hour refresher annuity course prior to license renewal every two years.
II. Identify and discuss contract provisions that are typically common to annuities

PROVISIONS COMMON TO MOST ANNUITIES

While each annuity described has its own unique characteristics, certain provisions are common to all contracts. This section covers the provisions commonly found in all annuities, after which we will look at those specific to fixed, equity-indexed and variable annuity contracts.

BONUS PROVISIONS

Some companies offer a "bonus" rate of interest that will be paid on top of the current, or "base" rate offered on the contract. Interest rate bonuses are generally guaranteed for one interest-crediting period, which is usually one year. The bonus may be in the form of an additional interest rate credited in the first year, or it may be a percent of premium which is credited to the contract immediately, which simply adds an amount to the contract owner's premium deposit at contract issue. Bonuses are popular with variable annuities.

Not all annuity contracts contain bonuses, but those that do are in one of two forms - interest rate bonuses or premium bonuses. Interest rate bonuses vest over the course of a contract year, while premium bonuses vest immediately. If explained and deployed suitably, bonus annuities can be a valuable tool, provided consumers understand that bonuses eventually come to an end. There have been instances where agents misrepresented bonus annuities in presentations and advertisements. The "teaser rates" attached to the first year rate were never explained properly by the agent or in the advertisements. Upon renewal, interest rates were far lower than the first year rate but surrender charges associated with such contracts which made liquidation too costly. As an added safeguard, new provisions of the California Insurance Code (CIC) require any product-specific annuity advertisement targeted at seniors 65 and older to have written approval from the insurer (§787, CIC). Hopefully, this will eliminate deceptive advertising practices regarding bonus annuities.

Agents should be careful when working with clients who already own an annuity and are thinking of exchanging it for a different annuity with a bonus feature. Even if the surrender period on the current annuity contract has expired, a new surrender period will generally begin when it is exchanged for a new one. Under some annuity contracts the insurer will revoke all bonus payments made within a specified period if clients make a withdrawal, if a death benefit is paid to beneficiaries, or under certain other circumstances.

A. Issues ages (Section 10112 of the CIC)

ISSUE AGE PROVISIONS (Section 10112 of the CIC)

There is no specific California law governing the maximum issue ages for annuities, and most insurers will issue an annuity contract up to age 85 or even older.

There are, however, rules relating to minimum issue ages. In California, a person younger than 18 years of age is a minor. Under provisions of California Probate Code and California Insurance Code (Section 10112), a minor does not have the right to contract for life or disability insurance or annuity contracts.

The California Uniform Transfer to Minors Act (UTMA) allows minors to own investments and other types of property. A donor appoints a custodian and irrevocably gifts money to a trust. The property then legally belongs to the minor but is controlled by the custodian until the minor reaches the age of 18 (which may be extended to a maximum age of 25) (California Probate Code, Section 3920.5). Agents should consult their insurer when minors are involved.
B. Maximum ages for benefits to begin

**Maturity Date - Maximum ages for benefits to begin**

Every deferred annuity contract specifies a maturity date or annuity date, which is the date on which annuitized payments are scheduled to begin. A contract's maturity date usually is the later of 10 contract years or the contract anniversary that falls in the year the annuitant reaches age 85. (In some contracts, the maturity age is 100.) Most insurers allow a contract owner/annuitant to continue the deferral period for some time past the maturity date or annuitize the contract before the maturity date. Typically, an annuity contract provides the insurer has a right to require proof that the annuitant is living on the date of any annuity payment.

C. Premium payments (Section 10540 of the CIC)

**PREMIUM PAYMENT PROVISIONS (Section 10540 of the CIC)**

**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 of the CIC)

California statutes regulate and set limits on the amount of premiums allowed to be collected for life insurance premiums as is seen in CIC Section 10540 shown here:

"An incorporated life insurer issuing life insurance policies on the reserve basis may collect premiums in advance. Such insurers may also accept moneys for the payment of future premiums related to any policies issued by it. No such insurer may accept such moneys in an amount to exceed (1) the sum of future unpaid premiums on any such policy or (2) the sum of 10 such future unpaid annual premiums on any such policy if such sum is less than the sum of future unpaid premiums on any such policy." (CIC Section 10540)

However, in regard to annuities, the company is not limited as to the amount of funds an insurer can accept for the purchase of annuities. The final paragraph of that section is shown here:

"This section shall not limit the right of such insurers to accept funds under an agreement which provides for an accumulation of such funds for the purpose of purchasing annuities at future dates." (CIC - Section 10540)

Companies accept premium payments in a variety of ways from single sum to periodic fixed amounts, such as monthly or flexible amounts such as periodic and/or sporadic payments.

Some companies have a minimum premium requirement. It can vary widely from company to company. Some have a minimum premium to start, but allow for lesser amounts for subsequent payments. Companies generally have different policy forms that accept varying types of premium payments. Monthly, quarterly, annual, and single premiums are generally accepted by most companies.

**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

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determined by the purchaser, and immediate annuities, providing for immediate commencement of the payout Year: 1997 sa 203 (Lewis, Chapter 28), Insurers: mortality tables.

An act to amend Sections 10163.2, 10489.2, and 10489.3 of the Insurance Code, relating to insurance.

- Existing law regulates the types of benefits to be paid under a policy of life insurance in the event of a default in premium payments or upon surrender of the policy, and also regulates the manner in which reserves are to be maintained by insurers issuing life insurance policies and annuity and pure endowment contracts.
- Existing law provides for insurers to use certain mortality tables for these purposes that have been approved by the Insurance Commissioner through promulgation of a regulation. This bill alternatively allows the commissioner to approve mortality tables through issuance of a bulletin.7

All companies have provisions regarding payment of premiums. Annuity contracts accept flexible premiums or a single premium. Since flexible premium contracts are designed to encourage systematic saving, insurers typically set relatively low requirements for additional deposits.

**MINIMUM & MAXIMUM PREMIUM PAYMENTS**

Companies generally set minimum and maximum limits on the premium amounts they will accept. Minimum limits are set in order to control the administrative costs the company incurs to credit each premium to the contract. Minimum and maximum limits vary among companies and types of contracts. Most insurers set maximum allowable deposits based on the insurer's ability to assume the liability of the contract.

1. The income will be less than the income using life only annuitization settlement. Because life expectancies of the "uniform table" are longer than standard mortality tables.
2. The beneficiary maintains the tax-deferred status on the unpaid death benefit. Under an annuitization option, funds no longer benefit from tax-deferral.

**D. Surrender charges (Section 10127.10, 10127.12, and 10127.13 of the CIC)**

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.

While many companies vary in how they go about arranging their surrender charges, most follow a decreasing percentage charge over a number of years. In fixed annuities this in generally referred to as surrender fees. In variable annuities, this charge is also referred to as a "deferred sales charge".

Some companies charge this decreasing percentage each year counting from the issuance date of the annuity contract on the amount of the funds withdrawn or surrendered. This simple format applies typically to single deposit / premium contracts.
Others apply the decreasing percentage for the number of years to each deposit that the annuity holder makes into the annuity. This typically applies to flexible premium annuities. Each deposit is subject to its own decreasing percentage over the specific number of years and is kept track of by the company and calculated on the amount of the withdrawals and surrenders, both partial and full.

An example of an 8-year surrender charge schedule might look like the following:

<table>
<thead>
<tr>
<th>Contract Year</th>
<th>Withdrawal Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>8%</td>
</tr>
<tr>
<td>2</td>
<td>7%</td>
</tr>
<tr>
<td>3</td>
<td>6%</td>
</tr>
<tr>
<td>4</td>
<td>5%</td>
</tr>
<tr>
<td>5</td>
<td>4%</td>
</tr>
<tr>
<td>6</td>
<td>3%</td>
</tr>
<tr>
<td>7</td>
<td>2%</td>
</tr>
<tr>
<td>8</td>
<td>1%</td>
</tr>
</tbody>
</table>

Note: These surrender charges do not reflect the 10% penalty imposed by IRS if withdrawals and surrenders are made prior to age 59%.

California statutes, discussed previously in “Rights and obligations of the insurance company” require specific disclosures for surrender charges to seniors and other purchasers with special references to fixed annuities and variable annuities.

**SURRENDER CHARGES (Sections 10127.10, 10127.12, and 10127.13 of the CIC)**

Almost all deferred annuities have surrender charges. These charges are assessed during the early years of a contract if the owner liquidates or surrenders the annuity before the insurer has had an opportunity to recover the cost of issuing the contract. In addition to recovering issuing costs, the surrender charges also provide some protection against the risk that increasing interest rates will result in contract owners surrendering their annuity contracts prematurely, forcing the insurer to liquidate its underlying investments at an inappropriate time. Surrender charges help offset the potential loss in the insurer's portfolio if interest rates escalate after a contract owner purchases the annuity. The penalty is usually expressed as a percentage and assessed against the premium deposited or the account value.

**Example of Surrender Charge Schedule**

<table>
<thead>
<tr>
<th>YEAR</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
</tr>
</thead>
<tbody>
<tr>
<td>SURRENDER CHARGE</td>
<td>7%</td>
<td>7%</td>
<td>6%</td>
<td>5%</td>
<td>4%</td>
<td>3%</td>
<td>2%</td>
<td>0%</td>
</tr>
</tbody>
</table>

- the applicable surrender charge period; and
- any and all penalties associated with surrender of the contract.

This requirement can be met through a notice in 12-point bold print on the cover page making the mandated disclosures or by indicating the location of this information in the policy. **Annual Statement Information** insurers normally furnish their annuity contract owners with annual statements concerning their contracts. When these annual statements are provided to a senior citizen, they must include the contract's current:

- accumulation value; and
- cash surrender value.
SURRENDE R CHARGES IN FLEXIBLE PREMIUM ANNUITIES

Some flexible premium annuities incur a new surrender schedule for each additional deposit. Because they no longer have an income from employment, seniors may need to access an annuity sooner than working-aged adults. Therefore, annuities sold to seniors should not subject additional deposits to new surrender charges.

1. Market value adjustment

MARKET VALUE ADJUSTMENTS (MVAs)

Some annuity contracts have a market value adjustment feature. If interest rates are different when the annuity is surrendered than when it was purchased, a market value adjustment may make the cash surrender value higher or lower. Since the contract owner and the insurance company share this risk, an annuity with an MVA feature may credit a higher rate than an annuity without that feature. The MVA can be positive or negative.

- If interest rates have fallen, the MVA will be positive. It will offset at least a portion of any applicable surrender charges, and perhaps even add to the annuity's surrender value.
- If interest rates have risen, the MVA will be negative and will be added to any applicable surrender charges, further decreasing the surrender value.

Some MVA products on the market today do not guarantee principal or minimum interest. With these contracts, the market value adjustment can be negative enough to cause a loss of principal, even if a contract owner has owned his or her contract for a number of years. The market conditions that would bring this about would be a rapid and substantial rise in interest rates. Because of this risk, these kinds of MVA products must be registered as securities, and they fall under the category of variable annuities.

2. Explain the impact of surrender charges on principal

Most contracts impose a fee if the contract is surrendered within the first five to 10 years. This is to cover upfront costs and fees paid by the insurance company paid including the commission to the person who sold the annuity. The higher the fees paid, the longer and higher the surrender penalty will be.

Yield vs. Liquidity

Clients demanding easy access to their money should be prepared to settle for lower overall yields. Agents need to go farther to determine special needs such as the potential for large sums of money to pay for a potential illness or nursing home. Certain contracts allow penalty free withdrawals for special circumstances. Due care dictates that agents carefully and clearly explain all surrender charges associated with the contract and when they occur.

3. Surrender charge waivers - triggering events

CRISIS WAIVER PROVISIONS

Crisis waivers allow policyholders to liquidate some or all of the annuity's value due to catastrophic events free of surrender charges.

The Variable Annuity Research and Data Service (VARDS) reports that 161 variable annuity contracts offer some type of waiver. Annuity contracts may contain some or all of the following crisis waivers.
a. Nursing homes and similar facilities

Nursing Home Waiver

The nursing home waiver eliminates surrender charges upon withdrawal in the event of a nursing home admission.

- May be annuitant or owner triggered
- May take effect immediately or beginning on the first anniversary
- Usually requires confinement of 30, 60, or 90 consecutive days
- Benefit may be reduced for older purchasers
- Attending physician's statement may be required along with a completed claim form.

While a 90-day confinement period before benefits kick in may be typical, some insurers impose a 180-day confinement period to a "licensed nursing facility."

Hospital Waiver

A hospital waiver which eliminates surrender charges upon withdrawal in the event of an extended hospital confinement after the annuity was purchased.

- May be annuitant or owner triggered
- May take effect immediately or beginning on the first anniversary
- Usually requires confinement of 30, 60, or 90 consecutive days
- Benefit may be reduced for older purchasers

b. Terminal illness

Terminal Illness Waiver

The terminal illness waiver eliminates surrender charges upon withdrawal if diagnosed with terminal illness.

- Terminal illness may be diagnosed differently (i.e. less than 6 months to live, less than 12 months to live)
- May be annuitant or owner triggered
- May take effect immediately or beginning on the first anniversary
- Will require certification from a doctor that life expectancy is only a matter of months.
- Benefit may be reduced for older purchasers (e.g. for purchaser older than aged 75, only 50% of account value may be surrendered)

c. Unemployment

Unemployment Waiver

The unemployment waiver eliminates surrender charges upon withdrawal if unemployment occurs, provided the annuity was purchased prior.

- Unemployment must be involuntary
- May require proof of gainful employment
- May be annuitant or owner triggered
d. Disability

Disability Waiver

The disability waiver eliminates surrender charges upon withdrawal if physical disability develops.

- May require Social Security Disability benefits as a prerequisite
- May be annuitant or owner triggered
- May take effect immediately or beginning on the first anniversary
- May not be available if over the age of 65 at the time of purchase

e. Charges and fees

CRISIS WAIVER CHARGES AND FEES

In most cases, there’s no extra charge for waivers because they’re built into the contract when purchased. Variable annuity contracts may offer crisis waivers for an additional expense. Certain tax consequences could apply to such withdrawals. Check with a tax adviser.

f. Death

SURRENDER CHARGES AT DEATH

If death occurs during the surrender period, some contracts waive surrender charges and some do not unless the beneficiary takes the proceeds over a five-year distribution. Agents who sell annuities to seniors need to exercise full disclosure. Agents need to fully explain how a surrender charge would impact the death benefit if heirs elect not to take the distribution over five years. Insurers assess these surrender charges in three ways:

1. Account value
2. Premium deposit
3. Loss of interest

Account Value and Premium Deposit Methods

The account value method uses a fee structure based on a percentage of the full accumulated account value at the time of surrender, whereas the premium deposit method is based on a percentage of the premium or premiums that the contract owner deposited into the contract.

- With the premium deposit method, the surrender charge percentage is high in the initial years, but reduces over time to zero.
- With the account value method, surrender charges that disappear after a certain number of years, but the percentage is fixed at 4 percent. This information can be useful when comparing one contract to another.

Loss of Interest

With this type of surrender charge, the contract owner is penalized by a loss of interest over some period of time, usually six months to one year. Loss of interest surrender charges are found on many of the certificate annuities, which creates a close parallel to a bank CD, which typically expresses premature withdrawal penalties as a loss of interest.
Agents should review the provisions of the contracts they sell to determine whether or not they contain surrender charges and what type and fully disclose them to buyers.

4. Include the required notice & printing requirements

**Required Notice & Printing Requirements:**

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 or issued for delivery in this state must 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:

- **E. Policy administration charges and fees**

**Annuity Fees and Expenses**

Just like other investments annuities have fees and expenses. Costs vary from product line to product line and company to company, and that variable annuities have more features than fixed annuities, so fees and expenses within a variable annuity are generally higher than those found in fixed annuities. A list of the types of fees for annuities is as follows: The fees or charges that are often incurred in annuities, particularly in variable annuities, include:

- **Investment Management Fees.** These fees run from a low of about 0.25 percent to a high of about 1 percent
- **Administration Expense and Mortality Risk Charge.** This charge ranges from a low of about 0.5 percent to a high of about 1.3 percent.
- **Annual Maintenance Charge.** This charge typically ranges from $0 to $100.
- **Charge Per Fund Exchange.** This charge generally ranges from $0 to $10, but most funds will permit a limited number of charge-free exchanges per year.
- **Maximum Surrender Charge.** Surrender charges vary by company and policy and generally phase-out over a number of years. If the charge is lower, the phaseout range tends to be longer. For example, typical charges and phaseout periods are 5 percent of premium decreasing to 0 percent over 10 years or 8 percent of premium decreasing to 0 percent over 7 years.

**PREMIUM TAXES**

Several states, including California, impose taxes on the annuity premiums that an insurance company collects. However, in most of those states, annuities funding qualified plans are exempt from those taxes. Premium taxes range from .5% to 3.5%, depending on the state. The significance of premium taxes to contract owners is that they ultimately bear the cost. The method of assessing premium taxes should be covered in an annuity contract and should also be explained in the sales presentation.

- **F. Withdrawal privilege options**

**WITHDRAWAL PRIVILEGE PROVISIONS**

Annuities are designed to be long-term investments, however, to compete with other investments, insurers needed to provide some liquidity during the accumulation period of the annuity. Insurers usually allow policyholders to withdraw a portion of the annuity's value free of surrender charges. The amount available differs by contract, but they usually fall into one of three “Free” withdrawal types:
• Interest earnings; or
• A percentage of premium deposited; or
• A percentage of the annuity's value

The “free” amount is typically accessible each year. If a larger amount is withdrawn, it may be subject to withdrawal charges. Clients may lose any interest above the minimum guaranteed rate on the amount withdrawn. Some annuities waive withdrawal charges in certain situations, such as death, confinement in a nursing home or terminal illness.

Tax penalties for withdrawal

Even though the withdrawal may be free of surrender charges, tax penalties may still apply. The federal government may impose tax penalties on interest income withdrawn before age 59½. If the annuity is a tax-deferred investment. All interest income is taxable as ordinary income at withdrawal.

SYSTEMATIC WITHDRAWALS

Some individuals do not wish to give up the control over their capital that annuitization entails. For these individuals, systematic withdrawal plans provide a way to obtain a regular income from their annuity fund. Although the amounts withdrawn are not subject to favorable tax treatment, interest continues to be credited to the annuity fund on a tax-deferred basis. And although the income stream is not guaranteed to last for the individual's lifetime, the fund remains within the individual's control. And the individual still has the option of annuitizing the fund if he or she should wish to do so at some point in the future.
III. Identify and discuss income distributions 10%

A. Introduce the application of a split annuity in retirement planning

THE SPLIT ANNUITY CONCEPT

Split-funding can be useful for people who have a need to generate spendable income over a certain number of years, but also want to preserve their capital.

A Split Annuity is a combination of two annuity products. A single premium immediate annuity and a single premium tax deferred annuity. Structured in such away as to produce immediate income for a guaranteed period of time and to restore the original principal at the end of that time period.

- A Deferred Annuity is used to restore the original principal at the end of the guaranteed period.
- The Immediate Annuity provides a guaranteed monthly income for the same time period.

The immediate annuity is used to generate an income stream that is guaranteed not to change for some period certain, typically 5 to 10 years. And, if non-qualified funds are used, only the interest income portion of the immediate annuity will be subject to income taxes, creating tax-advantaged income.

Advantages of a Split Annuity

- **Dependable Income**: The Immediate Annuity supplements income by providing a safe, predictable, and guaranteed cash flow. Depending on income needs, the Immediate Annuity can generate a stream of monthly income anywhere from five to twenty years.
- **Tax-Advantaged Income**: Since a significant portion of monthly income from the Immediate Annuity is considered a return of the original investment, it is tax-advantaged.
- **Tax-Deferred Growth and Principal Preservation**: The Deferred Annuity portion of the split-annuity concept offers tax-deferred growth and an interest rate that historically has been higher than average CD rates. In addition, original principal is restored at the end of the guaranteed period.

Example of a Split Annuity

This illustration is based on a guaranteed interest rate of 6.25% for 8 years. Withdrawals from an annuity prior to age 59½ may result in a 10% penalty tax imposed by the IRS.

<table>
<thead>
<tr>
<th>Beginning with $100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Immediate Annuity $38,430 at 6.2%</td>
</tr>
<tr>
<td>Monthly Income $485.37</td>
</tr>
<tr>
<td>Annual Income $5,824.48</td>
</tr>
<tr>
<td>for 8 years for which 82% is not taxed</td>
</tr>
<tr>
<td>Total Income before Taxes $46,595.83</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
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<tr>
<td></td>
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<tr>
<td></td>
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<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>
B. Introduce the various settlement options

Annuitization Payout Options

Annuitization is the process of converting the lump sum in an annuity into an income stream. There are several annuitization options to select from. The most popular are listed below:

1. Life
   - **Life Only** - Payments continue for life and end upon the death of the annuitant with no refund. The risk with this option is that they could die before receiving the full accumulated value of the investment.
   - **Life with period certain** - With this option equal payments are made throughout the lifetime or to the beneficiary for a guaranteed minimum period of time.

2. Joint survivor
   - **Joint and Survivor** – This payout option provides for payments over the lives of two individuals and can also be combined with period certain options.

3. Period certain
   - **Period Certain** - Payments continue for a selected period either to the annuitant or their beneficiary.
   - **Fixed period** – The owner decides how many years they want to receive income payments and the insurer determines the amount of each income payment.
   - **Fixed amount** – The owner decides how much the income payments are to be and the insurer will calculate how long the payments last.

4. Cash refunds
   - **Cash Refund** - Payments continue for life. However, if the annuitant dies before the initial deposit is recovered, the beneficiary receives the balance as a lump sum.
   - **Installment Refund** - Payments continue for life. However, if the annuitant dies before the initial deposit is recovered, payments continue to the beneficiary until the balance has been recovered.

C. Discuss the advantages and disadvantages of annuitization options

Annuities have the unique capability to guarantee an income that will last as long as someone lives. Today's ever extending lifespans make such a guarantee a more significant consideration than ever. The longer people can be expected to live after retirement, the more crucial it is to ensure that they will have adequate income over that entire period. Without the guaranteed lifetime income that annuities can provide, people are faced with a choice of either being so careful about their expenditures that they can't enjoy the full benefits of the fruits of their working years, or perhaps spending too freely and facing destitution in their old age. Without constraints on cash flow, most households start out after retirement by consuming too much relative to their resources and are compelled to reduce their standard of living within a few years. Only annuities allow individuals to maximize the liquidation of their assets while providing them with a guarantee that they can never outlive their income. Some individuals are reluctant to annuitize their retirement fund because in the event they die prematurely, they would have paid a large premium and received only a relatively small number of payments in return. For these individuals, period
certain options can ensure that the annuity will continue to make payments to a beneficiary for the balance of the certain period, even if the annuitant dies before that time.

Alternatively, a refund option can be chosen which will ensure that a beneficiary will enjoy the balance of the original amount paid for the annuity in the event that the annuitant dies before receiving payments totaling that amount. However, such guarantees come at a price. If the company is obligated to continue payments for a given period in the event an individual dies soon after premium conversion, the premiums of individuals who die prior to reaching life expectancy will no longer completely cover the payments that must be made to individuals who outlive their life expectancy. To make up for the deficiency, annuity payment amounts are smaller when guarantees are built into the payment option.

The following table illustrates the different benefit payments that a $100,000 annuity fund would generate, depending on the payout option selected. As you can see, the more guarantees the option provides, the smaller the monthly payment.

<table>
<thead>
<tr>
<th>Payout Option</th>
<th>Amount of Monthly Payment*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life only</td>
<td>$ 789</td>
</tr>
<tr>
<td>Life only with 10-year certain</td>
<td>$ 737</td>
</tr>
<tr>
<td>Joint life and 50 percent survivor</td>
<td>$ 708</td>
</tr>
<tr>
<td>Joint life and 100 percent survivor</td>
<td>$ 664</td>
</tr>
<tr>
<td>Joint life and 50 percent survivor with 10-year certain</td>
<td>$ 698</td>
</tr>
<tr>
<td>Joint life and 100 percent survivor with 10-year certain</td>
<td>$ 663</td>
</tr>
<tr>
<td>5-year certain</td>
<td>$1,802</td>
</tr>
<tr>
<td>10-year certain</td>
<td>$1,077</td>
</tr>
</tbody>
</table>

*Assumes the annuitant is a male, age 60, and his spouse/survivor is also 60 years old. The annuitant’s life expectancy is 17.5 years; joint life expectancy is 25.7 years.
IV. Identify and Discuss Variable Annuities

Variable Annuities

- Growth or loss based on performance of investment sub-accounts
- Principal as well as previous earnings are subject to risk

The annuity owner may choose to invest in a broad spectrum of separate accounts, which are similar to mutual funds. In contrast with fixed rate annuities, cash values depend on the market value of the underlying assets in the selected separate accounts. Variable annuity owners bear the market risk of investment without minimum interest rate guarantees. However, they have the flexibility to choose their investment portfolio and the potential to earn far greater total returns than on fixed rate annuities.

Variable annuities generate returns that fluctuate in value over time, based on the performance of the underlying portfolios they are invested in. Since the stock market has generally outpaced inflation, variable annuities are useful in protecting against the effects of inflation.

A variable annuity is designed to take advantage of the investment opportunities found in the stock market. Like other deferred annuities, variable annuities enable clients to accumulate money tax-deferred in order to provide an income at a later date. Variable annuities offer the choice of several investment divisions such as stocks, bonds, and money market funds, which can cause the rate of return to fluctuate with market conditions. The amount of money that the insurance company will pay upon annuitization depends on which investments selected and how they performed during the accumulation period. With a variable annuity, the owner, not the insurance company, assumes the investment risk. There is no guarantee of principal. There is no guaranteed minimum return. The value of the annuity depends on the performance of its underlying investments. Because the owner bears the investment risk, variable annuities are regulated as securities. In addition to a state insurance license, sales representatives must have the appropriate state and federal securities licenses to sell variable annuities and must comply with state and federal securities regulations in their variable annuity sales and service activities.

Variable annuities are sometimes used by investors who like to trade (buy and sell) mutual funds often and who do not need their money for many years to come, especially those in a very high tax bracket now who expect to be in a much lower tax bracket at retirement.

VARIABLE ANNUITIES

A variable annuity is a type of investment offered by an insurance company which is designed to help an investor save for and create a stream of payments during retirement. The investor gives the insurance company a sum of money that is invested according to the investor's objectives. Money is then allocated among professionally managed variable subaccounts selected by the client.

During a variable annuity's accumulation period, an investor's assets increase or decrease based on the investment performance of the selected subaccounts; investors are not guaranteed a specific rate of return. The subaccount investments of a variable annuity are subject to market fluctuation.

During the payout period, assets that have accumulated may be returned to the investor based on the annuitization option (either fixed or variable) and the annuity payout option the investor selects. Investors may also take discretionary withdrawals that may be subject to tax penalties or surrender charges.

The Objective is to provide investors the opportunity for market appreciation with tax-deferred accumulation and future (retirement) income.
Variable annuities may be suitable for individuals who are interested in long-term growth for purposes such as retirement planning.

Product Features

- **Lifetime Income** - Annuities can provide income for various lengths of time, including a lifetime. A lifetime annuitization option is normally only available from an insurance company.

- **Diversification** - Variable annuities enable individuals to invest in professionally managed subaccounts. A subaccount is similar to a mutual fund and is separate from the general assets of the insurance company. Subaccounts offer a diversified range of investment objectives, and each subaccount invests in a diversified portfolio of securities.

- **Professional Management** - A subaccount is managed by an individual or team of individuals who select the investments based on the subaccount's investment objectives.

- **Guaranteed Death Benefit** - If the policyholder dies, the beneficiary is usually guaranteed the amount originally invested, minus previous withdrawals. Some variable annuities offer death benefit options, which may increase death benefit over time.

- **Tax-deferred Growth** - Increases in the value of the annuity are not subject to taxes until withdrawn. Upon withdrawal, the earnings will be taxed at ordinary income tax rates. **Note:** There are no additional tax advantages to purchasing a variable annuity in IRAs, 401(k)s or other similar retirement savings vehicles.

- **Liquidity** - Most variable annuities allow policyholders to withdraw a portion of their investment. Withdrawal policies are defined in the annuity policy; withdrawals may be subject to a contingent deferred sales charge, loss or reduction of certain insurance benefits, and income taxes.

- **Living Benefit** - Some variable annuities enable the policyholder to elect an optional living benefit. These benefits can provide certain guarantees for contract withdrawals or annuitization payments during your lifetime.

- **Probate Avoidance** - When the death benefit in a variable annuity is paid to the named beneficiary, the proceeds are generally not included in the probated estate. However, the proceeds are subject to ordinary taxes of the beneficiaries and estate taxes. Investors seeking a death benefit not subject to taxation should consider life insurance.

- **Penalties for Early Withdrawal** - Withdrawals taken from an annuity prior to age 59-1/2 may be subject to a 10 percent federal penalty.

- **Market Value Fluctuation** - The value of variable annuities is subject to market fluctuation.

- **Benefit to Spouses** - Spousal beneficiaries may usually continue an annuity contract and maintain the tax deferred status, if so desired.

Generally, variable annuities have two phases:

- The "accumulation" phase when investor contributions - premiums - are allocated among investment portfolios - subaccounts - and earnings accumulate; and

- The "distribution" phase when the money is withdrawn as a lump sum or through various annuity payment options.

**Accumulation Units**

Premium dollars, deposited into a VA contract, are used to buy accumulation units based on the net asset value of the separate account funds at the time of purchase. A contract's accumulation unit has a given value when the contract is issued, and the initial premium deposit buys accumulation units at that price. For example, a $5,000 premium deposit in a VA in which the units are valued at $5 would purchase 1,000 accumulation units. The units represent the purchaser's ownership of the particular subaccount or subaccounts in which his or her premiums are invested. From that point on, the value of an accumulation unit fluctuates in response to the underlying funds in which the contract's values are invested; the insurer regularly (usually daily) revalues the units accordingly. Each revaluation reflects the gains or losses the investment account experienced. After deductions are taken for expenses and fees, future premium
deposits are applied to purchase additional accumulation units at their current value. The annuity accumulation unit value (AUV) is usually calculated daily.

**VARIABLE ANNUITY INCOME AND LIQUIDITY OPTIONS**

**Free Withdrawals**

Most variable annuities provide for withdrawal of a specified amount free of charge. Withdrawals in excess of the amount specified are possible but, in the early years of the contract, may trigger surrender charges. They may also encounter a "market value adjustment" (MVA). While a variable annuity's free withdrawal provision allows access to a portion of the contract's values without a surrender charge, any withdrawals still are subject to income tax and possibly a penalty if taken before age 59½.

**VARIABLE ANNUITIZATION**

Variable annuities can also be annuitized. Variable annuitization not only provides a guaranteed life income but can also provide the ability to respond to inflation. Like the cash values of variable annuities themselves, the income stream from variable settlement options also fluctuates.

Variable annuity contract owners have the option of annuitization; converting the funds in their annuities to income streams, guaranteed for a certain period of time, for life or for a combination of the two. Most companies offer several annuity options, based primarily on how long the income will last. First, the insurance company converts accumulation units to "annuity units", which result in payouts that are partly a tax-free return of principal and partly taxable earnings.

Meanwhile, the undistributed portion of the investment continues to compound, tax-deferred.

Variable annuitization involves a contract owner selecting an assumed interest or investment rate, known as the AIR. Based on that rate and the payment period, the carrier determines the initial (typically monthly) payment, then converts the payment into units based on the annuity unit value at the time of the initial payment. Subsequent distributions are of the same number of annuity units, but the value of the units varies, based on the performance of the underlying separate account.

Often the contract will offer a limited selection of AIRs, such as 3%, 5%, or 7%. Choosing the higher rate assumption will provide the highest initial income. But it will decrease the fastest if the net returns of the subaccounts fail to keep pace with the selected return. Determining which assumed interest rate to use depends on the risk tolerance of the client. A more conservative client will usually choose a more conservative AIR, hoping that the monthly income will go up over time. A more aggressive client will choose a higher AIR expecting that the income stream will stay high. Because the variable annuity houses fixed and separate accounts within the same product, the annuity owner has an option to create a mixture of fixed payments and variable payments. The contract owner allocates a dollar amount to the fixed account that will result in a guaranteed fixed payment stream for the term selected by the contract owner with the balance annuitized in the separate account.

Once annuitized, each payment is structured as a partial return of principal and part interest. Only the interest portion of the payment is taxable. In addition, clients can annuitize over their lifetime before age 59½ and the regular payments will not be subject to a tax penalty. Clients should consult their financial and/or tax advisor before deciding to annuitize.

Variable annuities are designed to be long-term investments, to meet retirement and other long-range goals. Variable annuities are not suitable for meeting short-term goals because substantial taxes and insurance company charges may apply if the money is withdrawn early. Variable annuities also involve investment risks, just as mutual funds do.
Bonus Credits

In an attempt to attract investors, many variable annuities now offer bonus credits that can add a specified percentage to the amount invested in the variable annuity, generally ranging from 1% to 5% for each premium payment made. Bonus credits, however, are usually not free. In order to fund them, insurance companies typically impose high mortality and expense charges and lengthy surrender charge periods. The more bonus interest offered, the higher or longer the surrender charge will be. Bonuses are not inherently bad, but the buyer must understand the necessary trade-off he or she accepts when purchasing a bonus annuity. The agent must advise the client to consider whether the bonus is worth more than its cost. The answer rests on a number of factors:

- Amount of the bonus credit
- Amount of the increased charges
- How long the client plans to hold the annuity contract

In a variable annuity the bonus may be accompanied with either a higher surrender charge or an additional percentage charged against the account values. Depending on how long the client holds the contract, the bonus annuity with increased annual charges may produce a lower overall account value than a lower priced annuity with no bonus.

The controversy over bonuses is not that they're being offered, but how they're being marketed. Some companies use this feature to pursue Section 1035 exchanges aggressively. The bonus is often used as an inducement to buy by offsetting any surrender charge that the contract owner faces when surrendering the existing contract. The SEC is investigating this practice.

The SEC has issued the following consumer warning: “If you already own a variable annuity and are thinking of exchanging it for a different annuity with a bonus feature, you should be careful. Even if the surrender period on your current annuity contract has expired, a new surrender period generally will begin when you exchange that contract for a new one. This means that, by exchanging your contract, you will forfeit the ability to withdraw money from your account without incurring substantial surrender charges . . . (and) the charges and other fees may be higher on the annuity with the bonus credit than they were on the annuity that you exchanged.” Agents who market bonus annuities must avoid unnecessary replacement activity and must diligently disclose the ultimate cost of the bonus to their clients so they can make an informed decision.

A. Additional License requirements

VARIABLE LICENSE IN ADDITION TO INSURANCE LICENSE.

Agents must submit acceptable proof of registration with the Financial Industry Regulatory Authority (FINRA). Acceptable proof must show that they have completed Series 6 and Series 63 per Section 260.217 of the California Code of Regulations.

1. Prospectus

PROSPECTUS

Variable annuities are considered securities and must be registered with the SEC. The SEC requires that all variable annuity sales materials include a prospectus, which contains all of the relevant information regarding the contract. The prospectus is a valuable tool which reveals any hidden charges not defined clearly in the supporting marketing materials. The prospectus outlines all costs and benefits, defines terms, discusses the issuer and gives the potential contract owner information. When used properly the prospectus can be an effective sales tool. Since variable annuities are securities, a prospectus must be
delivered to a prospect before, or at the time of, sale. The prospectus provides the client with essential information regarding the variable annuity. Information contained in a prospectus includes:

- Charges and fees
- Listing of subaccounts
- Description of what investments can be made in each subaccount
- Description of the subaccount objective
- Additional benefits
- How to determine the death benefit

2. Financial Industry Regulatory Authority (FINRA)

The Financial Industry Regulatory Authority

The Financial Industry Regulatory Authority (FINRA) is the largest independent regulator for all securities firms doing business in the United States. All told, FINRA oversees nearly 4,700 brokerage firms, about 167,000 branch offices and approximately 635,000 registered securities representatives. Created in July 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange, FINRA is dedicated to investor protection and market integrity through effective and efficient regulation and complementary compliance and technology-based services. FINRA touches virtually every aspect of the securities business—from registering and educating industry participants to examining securities firms; writing rules; enforcing those rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities; and administering the largest dispute resolution forum for investors and registered firms. It also performs market regulation under contract for The NASDAQ Stock Market, the American Stock Exchange, the International Securities Exchange and the Chicago Climate Exchange.

FINRA has approximately 2,800 employees and operates from Washington, DC, and New York, NY, with 15 District Offices around the country. FINRA believes investor protection begins with education. Using the Internet, the media and public forums, we help investors build their financial knowledge and provide them with essential tools to better understand the markets and basic principles of saving and investing. In addition, the FINRA Investor Education Foundation is the largest foundation in the U.S. dedicated to investor education. As of April 2009, the Foundation had approved approximately $46 million in investor education and protection initiatives through a combination of grants and targeted projects.

In today’s fast-paced and complex global economy, FINRA is a trusted advocate for investors, dedicated to keeping the markets fair, ensuring investor choice and proactively addressing emerging regulatory issues before they harm investors or the markets.

B. Typically common contract provisions

1. General vs. separate accounts

SUBACCOUNTS AND GENERAL ACCOUNT

Deposits made into variable annuities are invested into a separate account, divided into subaccounts. Subaccounts consist primarily of investments in stocks, bonds, mutual funds, and T-bills. Agents must understand that the investment risk is assumed by the investor.
SUBACCOUNTS

- Annuitant bears investment risk
- Consists of stocks, bond, mutual funds, etc.
- Sub-account assets are protected from potential claims of the insurance company's creditors

Many companies offering variable annuities also offer fixed account options to compliment the subaccounts. Money in the fixed account is held in the general account of the insurance company. The general account is a diversified investment portfolio that is used for investments in the fixed interest account. Unlike the subaccounts, the investment risk associated with money in the general account is assumed by the insurance company.

GENERAL ACCOUNT

- Insurer bears investment risk
- Consists of fixed income securities and real estate
- General account assets are not protected from potential claims of insurance company's creditors

2. Variable options

VARIABLE OPTIONS

Most variable annuities provide a range of options, from various types of stock and bond funds to money market funds and even a fixed account option. Premiums allocated to the fixed account option are guaranteed against investment risk and are credited with a guaranteed minimum return.

TYPES OF VARIABLE ANNUITY SUBACCOUNTS

Today, variable annuity buyers have many investment options for the allocation of their contract funds, with more being introduced each day. This has made it possible to choose investment options that match a buyer's goals, objectives and risk tolerance. The majority of variable annuities let clients choose among portfolios of stocks, bonds and money market instruments. They allocate money to purchase accumulation units in different portfolios, depending upon how aggressive or conservative they wish to be. Clients choose the portfolios in which they will invest from among those offered. The insurance company backing the annuity develops a relationship with a professional money manager, whose experts decide which specific stocks and bonds will be a part of each portfolio. In some newer variable annuities, clients can take advantage of more than one expert money manager, allowing even more flexibility in structuring their investment.

Owners are permitted to make transfers, or exchanges, of their funds among the available investment options, subject to some restrictions, such as frequency of transfers, number of transfers per year, minimum dollar amount or percentage of sub-account value transferred, or minimum dollar amount or percentage of value remaining in the sub-account.

ASSET ALLOCATION

Asset allocation is a process through which an investor allocates money across different asset classes, like stocks, bonds, cash and real estate. The process reflects an investor's personal attitudes about investing by addressing a variety of factors. When the contract owner elects this option, the company's asset managers move the money for the contract owner and change the allocation percentage for future deposits. The contract owner can designate part or all of his or her account to be moved and spread as the money manager sees fit.
Keys to Asset Allocation:

- Define Goals
- Gauge Risk Tolerance
- Look at the Big Picture
- Match Products to the Profile
- Choose a Mix that Suits Clients Needs

Through diversification, clients can help "spread" their risk by holding products that invest in different asset classes-equities, fixed-income, real estate, money market funds, and guaranteed accounts. Diversification helps offset the volatility of a single investment and take advantage of the earning potential of several. The key is asset allocation—choosing and maintaining the right combination of investments to reach clients goals, based on their risk tolerance and time horizon.

<table>
<thead>
<tr>
<th>INVESTOR PROFILE</th>
<th>INVESTMENT OBJECTIVE</th>
<th>ASSET CLASS COMPOSITION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conservative</td>
<td>Preservation of Capital</td>
<td>Fixed Income: 80%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Equity: 20%</td>
</tr>
<tr>
<td>Moderate-Conservative</td>
<td>Moderate Growth</td>
<td>Fixed Income: 59%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Equity: 41%</td>
</tr>
<tr>
<td>Moderate</td>
<td>Steady Growth In Asset Values</td>
<td>Fixed Income: 41%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Equity: 59%</td>
</tr>
<tr>
<td>Moderate-Aggressive</td>
<td>Moderately High Growth In Asset Value</td>
<td>Fixed Income: 24%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Equity: 76%</td>
</tr>
<tr>
<td>Aggressive</td>
<td>High Growth In Asset Value</td>
<td>Fixed Income: 6%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Equity: 94%</td>
</tr>
</tbody>
</table>

SUBACCOUNT REALLOCATION

An investor's financial objectives often change over time as well. Working-aged adults are usually focused on aggressive growth during their peak earnings years. As they approach retirement, however, they become more conservative. Investors in variable annuities have the flexibility to reallocate funds in subaccounts. Most variable annuity contracts allow for twelve or more transfers per year without charge.

3. Equity-based

EQUITY-BASED

GROWTH STOCK SUBACCOUNT

The investment of a growth stock subaccount is focused primarily on investments in common stock of companies that have above average growth potential. Growth stock subaccounts could be further specialized by targeting large cap, midcap, and small cap companies. Depending on the objectives, some growth funds are aimed at more aggressive growth while others seek more conservative capital gains, with some dividend distribution to provide limited income. Some funds even target smaller companies for better growth.
VALUE STOCK SUBACCOUNT

The objective of a value stock subaccount is to invest the majority of the assets in common stocks of companies that are under-valued in the market. Value stocks often perform well in periods where growth stocks perform poorly.

OTHER SUBACCOUNTS

Many other types of subaccounts are available in the variable annuity market of today.

Global Subaccounts

Global and international accounts are very popular today. Global funds seek to buy debt and equity issues from other prospering or developing nations, in addition to those of the United States. A variation of these funds is the international fund, which invests all of its money outside of the United States. Many advisors believe that the diversification global and international funds offer will be very desirable for long-term investors. Contract owners should be aware that most global and international funds impose higher than average management fees and expenses.

Precious Metals Subaccounts

Precious metals accounts are comprised of equity and debt instruments of companies involved in gold and other precious metals.

Social and Environmental Subaccounts

Social and environmental funds invest in companies that are socially or environmentally responsible.

Index Subaccounts

The index fund attempts to "mirror" a major index such as the S&P 500 and match its gains and losses. Some insurers include index options in their general accounts, providing both index returns and minimum guarantees of interest.

4. Risk-based

RISK-BASED

MONEY MARKET SUBACCOUNT

The objective of this subaccount is to provide the highest current return possible while preserving principle and maintaining liquidity. A money-market fund invests in very secure, short-term investments. Typically, maturities do not exceed one year. The fund usually consists of CDs, Treasury bills and commercial paper, which are short-term notes usually issued by large, financially secure corporations. Because of the short duration of the portfolios, interest rates on money-market funds usually are low when compared to other long-term investments.

Agents, should be aware that, although funds in this subaccount may preserve principle, surrender charges and taxes diminish the liquidity.
BOND SUBACCOUNT

The objective of a bond subaccount is to invest the majority of funds in corporate bonds or other debt investments including government or corporate bonds, both foreign and domestic. In a conservative bond fund versus a high yield bond fund, the underlying quality of the bonds will be strong.

Bond accounts tend to attract individuals seeking income from the variable annuity. Bond funds invest exclusively or primarily in debt securities.

Bond funds are much more subject to interest rate risk than stock and growth funds. As interest rates rise, the stock market may or may not respond negatively, but the value of a bond fund goes down and corresponding income is more susceptible to inflation.

HIGH YIELD BOND SUBACCOUNT

The investment objective of a high-yield bond subaccount would differ from a normal bond subaccount, since the underlying investments are lower rated bonds, and thus more risky. High risk bond funds purchase lower grade debt security than a more traditional bond fund, which may buy higher quality, lower yielding bonds.

FIXED RATE SUBACCOUNT (Section 10127.10 of the CIC)

Funds in the fixed account are held in the general account of the insurance company. Insurance companies offering variable annuities usually offer a fixed interest option. The objective of the fixed rate subaccount is to generate conservative and safe returns. The fixed rate subaccount offers a fixed interest rate that is guaranteed for one or more years. The fixed account in a variable annuity may also provide a minimum guaranteed interest rate.

C. Charges and fees

CHARGES AND FEES

Mortality and Expense Charges

The first fee typically imposed by an annuity will be what's known in the industry as a "mortality and expense" (M&E) charge. This fee pays for the insurance guarantee, commissions, selling, and administrative expenses of the contract. In general, these fees in a variable annuity will be charged as a percentage of the average value of the investment. According to the National Association of Variable Annuities (NAVA), the industry average M&E in 1997 was 1.15%. In a fixed annuity, these charges are usually incorporated in the insurance company's determination of the periodic interest rate or the annuity payment amount during the distribution phase. Some of the newer approaches to defining and periodically resetting the death benefit under a variable annuity contract are more expensive for the insurer. Consequently, the contracts that offer these benefits assess an additional mortality charge. Some carriers allow each buyer to choose between the traditional death benefit reset and the enhanced benefit reset at the higher cost. Keep in mind that the mortality and expense charge, as well as the administrative service charges, are assessed only against the funds held in the separate account; they never are assessed against funds held in the general account.

Mortality and expense risk charges are computed on and deducted from the net value of the separate account each day, but they are usually expressed in an annual percentage. It is usually shown as a combined charge, though many companies also show the breakdown into the mortality and expense elements. The combined percentages vary widely, ranging from about .5% for some companies to over...
2% for others. The company's mortality risk comes from two sources. One is the guaranteed lifetime payment options in the contract. The payment amounts are based on mortality statistics, but there is a chance that annuitants as a whole will live longer than the statistics indicate, making those lifetime guarantees more expensive to the company. The other source of mortality risk is the death benefit that the company guarantees to the beneficiary in the event of the owner's death prior to the annuity starting date. It is possible for the death benefit guaranteed by the company to be greater than the value of the separate account at the time of the owner's death. The mortality risk charge compensates the company for that possibility. The source of expense risk is that it may cost more to administer and distribute the contracts than the company anticipated. The company guarantees that its mortality and expense risk charges will not increase.

Other Fees

In addition to the mortality and expense charge, variable annuity contracts typically contain fees such as policy administration charges and investment management fees. The fees are listed and disclosed in full detail in the prospectus. These are some of the more common fees in addition to mortality and expense fees:

Administration Charges

An administrative service charge usually is expressed as a percentage of the funds invested in the separate accounts. It covers the cost of transferring funds from one separate account option to other separate account options or to the general account fixed option. It also covers the issuance of quarterly, semiannual or annual statements, depending on the insurer. Finally, it covers the costs of tracking deposits and the issuance of confirmations when monies are received or withdrawals are made. (This includes the processing of loans for variable annuities that are used to fund qualified plans such as 403(b), 401(k) or 401(a) plans.) This fee is calculated and deducted daily on an annualized basis from all monies in the separate/variable accounts within the contract. Most VA contracts stipulate that this fee will not increase. The insurer may deduct charges to cover record-keeping and other administrative expenses. This may be charged as a flat account maintenance fee (perhaps $25 or $30 per year) or as a percentage of the account value (typically in the range of 0.15% per year).

Contract Maintenance Charge

A yearly maintenance charge commonly is assessed to cover the administrative expenses associated with the variable annuity contract. This charge, usually applied at each contract anniversary date and upon surrender of the contract, covers the cost of issuing the policy, as well as other administrative costs. Some insurers waive this charge if the contract value is greater than a specified level. Many companies assess a policy maintenance fee to pay for the expenses of maintaining the contract on their books. This is often a flat dollar amount of between $25 and $40, assessed once each year. This charge may also be deducted on a quarterly basis from each separate account investment option to which the owner has allocated funds.

Management Fees

Management fees on subaccounts are assessed by variable annuities, and they are the same as an investment manager's fees in a mutual fund. These fees will vary depending on the various subaccount options within the annuity. In general, they will be somewhat less than those charged by a managed mutual fund within the same investment category -- though not necessarily. According to NAVA, the 1997 industry average for subaccount management fees was 82 basis points, or 0.82%. Management fees are the costs of managing a portfolio in a separate account. Management fees vary widely, depending on the type of fund. The range is generally from 25 percent of assets under management for a money-market fund to more than 1 percent for some global or international funds. The difference reflects the level of expertise needed to manage the fund and the higher costs associated with the start-up of any fund.
management fees and expense charges are *not* assessed directly to the contract owner. These charges are assessed against the subaccount values and are subtracted before calculating the accumulation unit value for the subaccount. Consequently, they affect the underlying fund’s performance.

**FEES FOR SPECIAL FEATURES**

**Charges for special features**, such as a:

- Stepped-up death benefits;
- Guaranteed minimum income benefits;
- Long-term care insurance; or
- Principal protection.

A description of the charges can be found in the prospectus of any variable annuity.

**SURRENDER CHARGES**

With most variable annuities currently marketed, rather than deducting the sales charge up-front, 100 percent of a contract owner’s funds are available for immediate investment. In return, to offset commissions that insurance companies pay to the agents who sell VA contracts, the companies assess surrender charges to contract owners who liquidate their contracts during the first several years. These surrender charges also may be called *contingent deferred sales charges*. The charge is assessed against any withdrawal that does not meet the contract’s free withdrawal provision.

Surrender charges in variable annuities do not usually apply at death, during the free-look, or to penalty-free withdrawals. When surrender charges are applied, the charge is made against premium contributions instead of account values. The length and amount of surrender charges is important to consider when evaluating suitability. Selling an annuity with surrender charges that last longer than the contract owner’s anticipated need for funds is not suitable.

**D. Dollar cost averaging**

**DOLLAR COST AVERAGING**

*Dollar cost averaging (DCA)* is a method of purchasing accumulation units within a variable annuity by making regular, level investments over a period of time. By using DCA, the contract owner can keep his or her average cost below the market. With the same amount invested on a regular schedule when the market price is higher, fewer shares will be purchased. When the market price is lower, more shares will be purchased. With deferred annuities, dollar cost averaging during the accumulation phase is virtually automatic. Where the deposit is a lump sum, dollar cost averaging is accomplished by allowing a portion of the investment to earn a fixed interest rate and systematically transferring portions into sub-accounts each month.

Dollar cost averaging does not offer a guarantee of gain or a guarantee against loss but over time it helps to average out the highs and lows in the market.
E. Death benefit guarantees (Section 10168.4 of the CIC)

DEATH BENEFIT GUARANTEES (Section 10168.4 of the CIC)

In fixed and equity-indexed annuities, the death benefit is usually the accumulated value or the surrender value. With variable annuities, due to the investment risk of the subaccounts, the death benefit fluctuates and could potentially be far less than the amount invested in the contract.

The Guaranteed Minimum Death Benefit is generally the greater of either the total amount of premiums, less withdrawals, or the current value of investments. Agents should carefully read the contract language for the variable annuity chosen to find out exactly what type of death benefit the company offers. Most variable annuity contracts available today also offer an enhanced or “stepped-up” death benefits by guaranteeing that the death benefit will never be lower than the highest account value on any contract anniversary. The stepped-up death benefit may also include any premiums paid (minus any withdrawals taken) since that time.

10168.4. For contracts which provide cash surrender benefits, such cash surrender benefits available prior to maturity must not be less than the present value as of the date of surrender 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 the amount appropriate to reflect any prior withdrawals from or partial surrenders of the contract, such present value being 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 such maturity value, decreased by the amount of any indebtedness to the company on the contract, including interest due and accrued, and increased by any existing additional amounts credited by the company to the contract. In no event must any cash surrender benefit be less than the minimum nonforfeiture amount at that time. The death benefit under such contracts must be at least equal to the cash surrender benefit.

F. Living benefit guarantees

LIVING BENEFITS GUARANTEES

A new trend in the VA market are Guaranteed Living Benefits (GLBs). Designed to ensure some minimum contract amounts, these new guarantees generally take one of three forms:

1. Guaranteed Minimum Account Value (GMAV)
2. Guaranteed Minimum Income Benefit (GMIB)
3. Guaranteed Minimum Income Payments (GMIP)

Guaranteed Minimum Account Value (GMAV)

The Guaranteed Minimum Account Value (GMAV) ensures that the contract's account value will be no less than a specified percentage of premiums paid after a specified number of years, such as 8 or 10. The amount of the guarantee exceeding the account value at the end of the specified period is added to the account value and the contract continues, with or without a new guarantee period. Annuitization is not required to realize this benefit.

Guaranteed Minimum Income Benefit (GMIB)

The most common living benefit. The Guaranteed Minimum Income Benefit (GMIB) ensures that a minimum amount will be available to convert to annuitized income at rates specified in the contract.
Consequently, a minimum income benefit is guaranteed. Risk to the insurer is at least partly managed by making the benefit contingent upon annuitization

**Guaranteed Minimum Income Payments (GMIP)**

*Guaranteed Minimum Income Payments (GMIP)* ensure that each annuitized income payment the annuitant receives under variable annuitization will never be less than a certain percentage of the first payment. This benefit has been recently added to immediate variable annuities, to help limit the possible fluctuation of monthly variable payments

**Guaranteed Minimum Withdrawal Benefit (GMWB)**

Allows for a certain minimum amount that may be withdrawn from the annuity, usually over a set period of time.

**Guaranteed Monthly Income Benefit Riders (GMIB)**

Regardless of how the subaccounts perform, this rider guarantees a competitive interest rate for the full term of the annuity provided the owner annuitizes upon maturity. This rider can be beneficial for both preretirees and seniors, since it adds a level of safety to the contract.

**Guaranteed Retirement Income Benefit (GRIB)**

One special type of variable annuity is the living benefit annuity, also known as a Guaranteed Retirement Income Benefit. The best living benefit annuities guarantee a minimum return over seven years, or the highest attained value on each anniversary during the surrender period, whichever is greater. In exchange for this living guarantee, the living benefit annuity has a surrender charge, or penalty for early withdrawal, no up-front bonus, and a slightly higher annual fee.

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V. Identify and discuss fixed annuities

Fixed Annuities

- Interest rates are fixed for a stated period of time
- Minimum interest rates are guaranteed for the policy duration
- Once credited, gains are not susceptible to loss in the future
- Principal is not subject to risk

Amounts credited to cash values are based on the insurer’s current declared rate, subject to a minimum guarantee of about 4 percent to 4.5 percent. Rates may be guaranteed for one to five years. The currently declared rate depends on the performance of the insurer’s general investment portfolio or general account, which is largely invested in fixed income investments such as bonds and mortgages. Similar to a savings account, once interest is credited, the cash value will not decline if the market value of the underlying assets in the insurer’s general account declines. The insurer bears the market risk.

Because fixed annuities typically attract people with low risk tolerance, the insurance company's approach to managing fixed annuity investments is conservative. Money deposited into fixed annuities is held in the general account of the insurance company where the insurance company assumes the investment risk. The general account is a diversified investment portfolio consisting of bonds, fixed income securities and real estate. Fixed annuities provide a guaranteed rate of return on the investment and a fixed, stable income in its payout phase. The insurer, not the insured, takes the investment risk. This steady retirement income is, however, subject to inflation.

- Fixed annuities invest in low-risk assets.
- Fixed annuities provide a relatively stable rate of return with low level risk comparable to a CD.
- They are considered a low-risk investment.

FIXED ANNUITIES

A fixed annuity is an investment vehicle offered by an insurance company that guarantees to pay a stated rate of interest for a specified period of time. The investor has the choice to accumulate the interest on a tax-deferred basis or take it as income. With a fixed annuity, the insurer, not the insured, accepts the investment risk.

During a fixed annuity's accumulation period, an investor's assets are invested for a specific period of time (the guarantee period). Generally, guarantee periods range from one to ten years; the longer the guarantee period, usually the higher the rate of interest. Renewal rates are announced near the end of the guarantee period. At that time, the investor needs to review their options.

During the payout period, the assets that have accumulated may be returned to the investor based on a fixed annuitization option. Investors may also elect to withdraw their interest. Withdrawals are taxed as ordinary income. IRS regulations may impose a 10% penalty if withdrawals are made prior to age 59½. Withdrawals of principal during the guarantee period may also be subject to surrender charges or market value adjustments.

The primary objective of fixed annuities is to provide investors growth of principal and interest that is free from taxes until withdrawn.

Fixed annuities are an investment alternative for investors seeking growth of principal for purposes such as retirement planning.
Product Features

- **Lifetime Income** - Annuities can provide income for various lengths of time, including a lifetime. A lifetime annuitization option is normally only available from an insurance company.
- **Choice of guarantee periods** - The guarantee period an investor selects should be based on their investment time horizon and diversification strategy. Fixed annuities generally offer guarantee periods from one to ten years.
- **Guarantee of Interest and Principal** - The value of a fixed annuity will increase every day that interest is added to the contract. Interest is usually compounded annually and credited daily. The guarantees offered by a fixed annuity are backed by the claims-paying ability of the issuing insurance company.
- **Tax-deferred Growth** - Interest accumulates tax-deferred and is not subject to taxes until withdrawn. Upon withdrawal, the earnings will be taxed at ordinary income tax rates. Note: There are no tax advantages to purchasing a fixed annuity in IRAs, 401(k)s or other similar retirement savings vehicles.
- **Flexible income options** - During the guarantee period, an investor has the option to take systematic withdrawals, usually limited to their interest. Investors have the option to start, stop and adjust their withdrawal amount, subject to certain limitations. An annuity’s income stream can also be guaranteed by the insurance company for as long as the investor lives.
- **Probate Avoidance** - Fixed annuity proceeds paid to the beneficiaries upon the investor’s death are excluded from probate on their estate; however, the tax-deferred earnings in the contract will be subject to ordinary income tax, and estate taxes would apply to the total value of the contract, if applicable.
- **Penalty for Early Withdrawal** - A 10 percent IRS penalty is assessed on any interest withdrawn from a fixed annuity prior to age 59-1/2.
- **Penalty for Early Surrender** - Investors are assessed a charge for the early surrender of fixed annuities.
- **Benefit to Spouses** - Spousal beneficiaries may usually continue tax deferral if so desired.

A. **Typically common contract provisions**

1. **Death benefits**

**DEATH BENEFIT**

One feature annuities offer that is absent from other investments is a guaranteed death benefit. The death benefit payable to the beneficiary of a deferred annuity prior to the annuity starting date is usually equal to the greater of either:

1. the total premium paid for the annuity to date, minus any withdrawals, or
2. the current accumulated value of the annuity fund.

If death occurs after a contract’s maturity date and after annuitized income payments have begun, payments will continue (or cease) as provided for under the distribution option in effect. Generally, no surrender charges or market value adjustments are applied in determining the amount of the death benefit.
a. **Lump sum vs. annuitization**

**OWNER’S DEATH**

Federal tax law requires that certain distributions be made from an annuity in the event that any owner of the contract dies. If the owner of the contract is not a natural person, then the annuitant will be considered the owner for the purposes of the rule, and a change of annuitant is treated the same as the death of an owner for tax purposes. Required distributions are as follows:

- **If an owner dies after** the annuity starting date, any remaining payments that are due under the annuity must continue to be made at least as quickly as payments were being made prior to the death of the owner.
- **If the owner dies before** the annuity starting date, the entire value of the annuity must either be distributed within five years of the date of the owner's death, or the value of the annuity must be annuitized within one year of the date of the owner's death.

b. **Provisions**

- **Lump-sum payout** – distribution of the entire account by the end of the calendar year following the year in which death occurs. Gain taxed accordingly.
- **Five-year rule** – requires that the beneficiary distribute the entire account by the end of the calendar year that contains the fifth anniversary of death. Gain taxed as distributions occur.

There is one exception to the rule requiring distributions in the event of an owner's death. If the beneficiary of the annuity is the surviving spouse of the deceased owner, then the surviving spouse is permitted to become the owner. Distributions will not be required until the surviving spouse's subsequent death. Other than surrender charges or charges for special features, the fees and charges for fixed annuities are included (or bundled) in the overall price and interest crediting structure of the product.

2. **Charges and fees**

**Fees and Expenses**

Most fees and expenses of a fixed annuity are factored into the stated annual percentage rate the investor is quoted. The rate quoted is the rate paid. Fixed annuity fees and expenses generally cover the insurance company's administrative expenses, the cost of offering the annuitization guarantee and profits to the insurance company and agent. Some fixed annuities may assess an annual contract fee, typically around $30.

**What are the fees associated with a fixed annuity and how do they work?**

Although there are fees associated with fixed annuities, you don’t pay them directly. Fixed annuity fees are reflected in the interest rates credited on the contracts.
3. Interest rate strategies

HOW THE INTEREST RATE IS DETERMINED FOR A FIXED ANNUITY

a. Annual

ANNUAL

The traditional deferred annuity offers an initial interest rate which is guaranteed for a period shorter than the term of the annuity itself. Most traditional annuities guarantee the initial interest rate for one year, although some products may offer a longer initial rate guarantee, like three years. The insurer re-declares a new interest rate each anniversary. There is a stated minimum guaranteed interest rate that the renewal rate may never fall below. During the accumulation period, money (less any applicable charges) earns interest at rates that change from year to year. Some annuity contracts apply different interest rates to each premium paid or to premiums paid during different time periods.

b. Multi-year

THE MULTI-YEAR GUARANTEE ANNUITY

Multi-year guarantee annuities are designed with an interest rate that is guaranteed for the full-term of the annuity. Since a client can accurately predict the value of the annuity throughout the life of the contract, they are especially useful for reaching a specific value at some time in the future such as retirement.

4. Interest rate crediting methods

METHODS OF CREDITING EARNINGS

When an insurance company invests fixed annuity funds, it uses conservative investments like high quality bonds and mortgages. When the interest rate period ends, the insurance re-declares a new rate using one of two methods:

a. Portfolio rates

PORTFOLIO RATES

Portfolio Rate Interest Crediting credits the same interest rate to new and existing policyholders. All annuity monies go into one large pool or portfolio. The total return of that portfolio is used to establish the interest rate for all contract owners who buy that annuity. When it comes to renewal time, the insurer looks at the entire portfolio, regardless of when each individual investor bought his or her contract, and establishes a renewal rate for the entire block.

b. New money rates

NEW MONEY RATES

New Money Interest Crediting credits interest by investing annuity funds in many different accounts according to similar interest rate cycles. When the cycle fluctuates, a separate account of investments is then used to capture the annuity funds received during this new environment. The insurer evaluates each of the accounts at renewal time to establish the renewal rate by looking at the cash flows from the underlying investments, reinvestment of the undistributed cash flows and the market value of the...
investment portfolio, as well as many other factors. The renewal rate of current policy holders will most likely be different than the interest rates offered to new policyholders.

c. First year bonus “teaser” rates

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.

d. Explain annualized interest rate calculations on bonuses that apply to fixed accounts

Bonus Credit Rider

Usually, this rider is offered on many deferred annuities as an incentive to buy. There is often a relationship with the surrender charge schedule and the amount of bonus interest offered. The more bonus interest offered, the higher or longer the surrender charge will be. In a variable annuity the bonus may be accompanied with either a higher surrender charge or an additional percentage charged against the account values. In an attempt to attract investors, many variable annuities now offer bonus credits that can add a specified percentage to the amount invested in the variable annuity, generally ranging from 1% to 5% for each premium payment made. Bonus credits, however, are usually not free. In order to fund them, insurance companies typically impose high mortality and expense charges and lengthy surrender charge periods. Bonuses are not inherently bad, but the buyer must understand the necessary trade-off he or she accepts when purchasing a bonus annuity. The agent must advise the client to consider whether the bonus is worth more than its cost.

The answer rests on a number of factors:

- Amount of the bonus credit
- Amount of the increased charges
- How long the client plans to hold the annuity contract

Depending on how long the client holds the contract, the bonus annuity with increased annual charges may produce a lower overall account value than a lower priced annuity with no bonus. The controversy over bonuses is not that they're being offered, but how they're being marketed. Some companies use this feature to pursue Section 1035 exchanges aggressively. The bonus may be used as an inducement to buy or as an offset to any surrender charge that the contractowner faces when surrendering the existing contract.
5. Minimum Guaranteed Interest Rates (Section 10168.25 of the CIC)

Minimum Guaranteed Rate (Section 10168.25 of the CIC)

Fixed annuities have a guaranteed minimum interest rate and a current rate that is higher than the guaranteed minimum. The minimum rate is guaranteed for the life of the annuity. The current rate is guaranteed for a shorter period, usually one year. Annuity owners can expect the current rate to change periodically while the guaranteed minimum rate represents the lowest rate the annuity will earn.

Minimum annuity interest rates reflect, in part, the reserving and nonforfeiture requirements that insurers must meet. In effect, the minimum interest rate provides a guaranteed worst-case scenario relative to a fixed contract's growth. For most fixed annuities, the minimum rate is 3 to 4 percent.

Current Interest Rate

The current rate is the rate the company credits to the contract at a particular time. The company will guarantee it not to change for some time period. Current rates offered on annuities vary much more widely and frequently than guaranteed minimum rates.

a. Low interest rate market and its impact on interest rates

<table>
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<th>Low Interest Rate Environment Impact on Interest Rates</th>
<th>In a Rising Rate Environment…</th>
<th>In a Falling Rate Environment…</th>
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</tr>
</tbody>
</table>

*This is the renewal rate for existing business as well as the initial rate for new business. It is determined by weighting half of the portfolio at 7 percent and half at 5 percent (5 percent derived from market rate minus spread).

*This is the renewal rate for existing business as well as the initial rate for new business. It is determined by weighting half of the portfolio at 5 percent and half at 7 percent (7 percent derived from market rate minus spread).
VI. Identify and discuss indexed annuities

THE EQUITY INDEXED ANNUITY

- Interest rates determined by changes in a major market index (i.e. S&P 500)
- Minimum interest rates are guaranteed for the policy duration
- Principal is not subject to risk

The equity-indexed annuity is a fixed annuity that credits interest based on changes in a major market index, like the S&P 500. If the index increases, then some or all of that increase is credited to the annuity. If the index decreases, the value of the annuity does not fall. The principal and all previously credited interest is preserved. The least an equity-indexed annuity can earn is 0%.

The returns on EIAs are linked to an equity index, such as the S&P 500 index. However, the annuity is not actually invested in the stocks making up the index. Like fixed annuities, the returns to EIAs are paid from the insurance company’s general account. However, the amount allocated to the EIA is based on some percentage of the appreciation in the reference index, subject to annual caps. If the index declines in value, a minimum guaranteed amount is credited to the EIA. In this way, EIAs provide the upside potential of the equity markets with the downside protection of more conservative general account investments.

Equity-indexed annuities offer consumers a potentially higher rate of return than a traditional fixed annuity, but without the downside risk of variable products. Equity-indexed annuities (also known as EIAs) are relatively new. The first equity indexed annuity became available in the early 90’s as a product that allowed consumers to participate in the stock market's upside without subjecting them to its potential downside. Since their introduction, these products have continued to gain popularity and sales are in the billions of dollars annually. In California, more than 100 equity-indexed annuities are approved by the Department Of Insurance. The theory behind all indexed annuities is virtually the same - to offer market-linked growth without the associated risk. There are, however, many different designs in the marketplace. This makes it extremely important for agents to thoroughly understand and explain to their clients contracts they sell.

Equity Index annuities provide a minimum guaranteed interest rate with excess interest crediting based on the movement of an external index. Equity index annuities share the same features as other fixed annuities:

- Tax deferral of interest compounding inside the annuity
- Lifetime income options
- Minimum interest guarantees
- Probate free death benefit if a beneficiary is named
- Interest earnings are often available through free withdrawals
- Regulated by an insurance product, not a security
- Withdrawals subject to IRS "premature distribution" rules
- Surrender charges

The original principal and previously credited interest are not subject to market risk. Even if the index declines the individual would receive no less than their original principal back if they decided to cash in the policy at the end of the surrender period.
THE INDEX

Index annuities may base the crediting of excess interest on movements of the S&P 500, Dow Jones Industrial Average, NASDAQ 100, Russell 2000 or other indices that are also used. Unlike an equity index mutual fund neither dividends nor capital gains are included in the index annuity calculation. No index-linked product is sponsored, endorsed, sold or promoted by any index.

Some companies have developed products with a variety of index options, including a traditional fixed interest rate strategy. By offering variety, the consumer can elect to allocate their deposit between the index options most suited to their needs. For flexibility, products typically allow for re-allocation among the indices each anniversary. When someone buys an equity-indexed annuity they own an insurance contract. They are not buying shares of any stock or index. Since an equity indexed annuity (EIA) is a fixed annuity it does not require a securities license to sell. Due to the unique nature of the EIA with its principal protection and index-linked returns, an EIA may be more appealing than standard fixed annuities without the market risk of variable annuities or mutual funds, particularly for those seeking a stable retirement income that can keep up with inflation. Since the EIA allows for protection of principal in down markets and provides for a zero percent return instead of a negative return during market declines, an EIA is ideal for clients who would like to participate in market returns yet are uncomfortable with market risk. As people age, inflation continues to erode the buying power and savings of clients. Over time, the highest investment returns have resulted from the equity markets. With the uncertainty of the stock market and low interest rates, clients are seeking safe alternatives to provide returns immune from market and inflation risks.

Withdrawal Privileges

Most EIAs offer a 10–20 percent standard withdrawal feature while providing a nursing home or terminal illness waiver that may allow for a substantial or complete withdrawal without penalty. Typically most contracts allow for full contract value without penalty upon death of the annuitant.

Term

The index term is the period over which index-linked interest is calculated. The interest is credited to the annuity at the end of a term. Terms are generally from one to ten years, with six or seven years being most common. Some annuities offer single terms while others offer multiple, consecutive terms. If the annuity has multiple terms, there will usually be a window at the end of each term, typically 30 days, during which clients may withdraw their money without penalty. For installment premium annuities, the payment of each premium may begin a new term for that premium.

Interest Compounding

It is important to know whether the annuity pays compound or simple interest during a term. While an annuity that pays simple interest may earn less, it may have other desirable features, such as a higher participation rate. To better understand the mechanics of an equity indexed annuity, agents need to understand the major crediting methods used to calculate index-linked returns in order to evaluate potential returns for a contract owner. On a traditional fixed annuity, the company declares an interest rate in advance and then credits that interest rate to in-force policies. In contrast, the interest rate credited to an equity-indexed annuity is the result of growth in an index, less fees taken by the insurance company. If the index goes up, the annuity is credited with at least a portion (from 60% to 110%, depending on the contract) of the increase. If the index goes down, however, neither the original principal nor any interest previously credited to the annuity is reduced.

The “indexing method” means the approach used to measure the amount of change, if any, in the index. There are several methods for determining the change in the relevant index over the period of the
annuity. These varying methods impact the calculation of the amount of interest to be credited to the contract based on a change in the index. Some of the most common indexing methods include **Point-to-Point, Monthly Averaged and High Water Mark**.

A. Primary interest crediting strategies

**Interest Rate Crediting Strategies**

An equity-indexed annuity is different from other fixed annuities because of the way it credits interest to the annuity’s value. Equity-indexed annuities credit interest using a formula based on changes in the index to which the annuity is linked. The formula decides how the additional interest, if any, is calculated and credited. The 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.

1. Monthly averaging

**THE MONTHLY AVERAGING METHOD**

The monthly averaging method takes the index value each month to arrive at an annual index average. The index average for the year is then compared to the index value at the start of the year. If the result is positive, the insurance company will then apply the participation rate, cap rate, and/or spread yield. For example, the ending index value of a monthly averaging method would be calculated as the last 12 monthly anniversary values added and divided by 12 to create an average annual value. In this case, averaging protects the contract holder from sudden declines in the index. This method helps prevent the risk of having no growth during years when the index may be volatile or suddenly turn downward just prior to the anniversary.

*The averaging method works best in volatile markets over a limited period of time.*

2. Point to point

**THE POINT-TO-POINT METHOD**

With this type of product, the value of the index to which the annuity is linked is marked at the time the contract is purchased and again at the end of its term. The difference in the index value between these two points is the basis for the amount of interest that will be credited to the annuity. The two most common versions of this strategy are annual point-to-point and long-term point-to-point.

The major disadvantage of the point-to-point method is the risk that the index might be at a low point on the date the second point is recorded, resulting in the loss of unrealized index gains if the index sinks just prior to the second end point. In conditions where the index is either volatile or in a declining trend, equity-indexed annuities using a monthly averaging method may be more suitable than a point-to-point strategy.

*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.*
a. Annual point to point

Annual Point to Point

An annual point-to-point would measure the index on the issue date and again one year later. With this option gains are credited to the annuity annually and the process of measuring index growth starts again each year.

b. Long term point to point

Long Term Point to Point

A long-term point-to-point evaluates the growth the same way, except the measurements are separated by a longer horizon. For example, a three-year point-to-point means the first measurement is taken on the issue date and the second at the end of the third year. No interest is credited until the annuity reaches this second point, three years later. For example, the index value was at 100 on the first day of the period. If the index value was at 150 at the end of the period the gross index gain would be 50% (150-100/100). The company would credit a percentage of this gain, by applying a participation rate. If the participation rate was 80% the index annuity would be credited with a total return of 40% interest (50% index gain x 80% rate) for the period. Regardless of which version of point-to-point is used, the difference between the two values (or points) represents the gain in the index before participation rate, cap rate and/or spread yields are applied.

3. High water mark

THE HIGH WATERMARK METHOD

A high watermark annuity measures the difference between the index value from the time the contract is purchased to the point when the index reaches its highest level in the given term. In a five-year contract, for example, the highest of the index’s value on all five anniversary dates would be the high mark. Like point-to-point and monthly averaging, some percentage of the growth will be applied to the contract using a participation rate, cap rate, and/or spread yield.

The high-water mark method performs best when the market rises to a high level and then surrenders a significant portion of the gain over the remainder of the contract term.

The high-water mark represents less than one percent of sales and is not a major method used today.

Low-Water Mark

This is a variation of the high-water mark annuity. A low watermark product measures the difference in the index value between the anniversary date on which the contract reaches its lowest mark and the end of the contract’s term. This difference is the basis for the amount of interest credited to the annuity.

4. Annual resets

THE ANNUAL RESET PROVISION

An important feature found in many equity-indexed annuities is the annual reset provision. With an annual reset design, the index to which the annuity is tied is marked at the beginning and end of each contract year. The difference in the index value each year is the basis for the amount of interest credited to the
product. Any declines are ignored. The annual reset provision has many benefits for seniors. First, the annual reset provision locks in gains each anniversary and protects all previous years’ interest from being lost in subsequent years. The annual reset provision also provides new growth potential each year by resetting the index starting point. This presents a new opportunity for gain after the index suffers a severe downturn the previous year by using the lower value as its reset point for the year ahead. Most seniors prefer fixed annuities to variable annuities partly because they can access income through interest withdrawals. With equity-indexed annuities, the annual reset provision is an important feature to evaluate when determining suitability for seniors. Without it, index gains cannot be credited annually and are not available to withdraw.

The annual reset method works well under volatile market conditions and has become popular in the past two years. This method also provided the best index participation potential when taking out periodic or systematic withdrawals.

5. Combination methods

EQUITY-INDEXED ANNUITIES MAY OFFER A COMBINATION OF METHODS

Each of the interest rate crediting strategies reacts differently to the market's performance. Some products offer a combination of interest rate crediting strategies. Many of today’s products include both monthly averaging and point-to-point methods. This offers the consumer the flexibility to decide how funds will be allocated at issue and funds can be reallocated each anniversary between methods and index options.

B. Spreads

Spread/Margin/Asset Fee

Some EIAs use a spread, margin or asset fee in addition to, or instead of, a participation rate. It is stated as a percentage deduction from the amount of indexed interest and it is used to cover the expense of purchasing index options and other underlying expenses. This percentage will be subtracted from any gain in the index linked to the annuity. For example, if the index gained 10% and the spread/margin/asset fee is 3.5%, then the gain in the annuity would be only 6.5%.

C. Cap rates

Cap Rate or Cap

Some equity-indexed annuities place a cap on the rate of interest that may be credited. Even if reference to the index would produce a higher rate, the rate credited to the annuity will not exceed the cap. Not all equity-indexed annuities have caps. They are often used in conjunction with a participation rate and are common in EIAs with an annual reset design. Annuities that have a cap may also have a higher participation rate.

D. Participation rates

PARTICIPATION RATES

A participation rate determines how much of the gain in the index will be credited to the annuity. The percentage stated (participation rate) is multiplied by the amount of increase in the index value to determine the indexed interest. For example, the insurance company may set the participation rate at 80%, which means the annuity would only be credited with 80% of the gain experienced by the index.
When the S&P 500 value increases 10 percent, an EIA with an 80 percent participation rate will receive indexed interest credit of 8 percent. The participation rate may vary greatly from one annuity to another and from time to time within a particular annuity. It is important for agents to be able to explain to clients how their annuity's participation rate works with the indexing method. A high participation rate may be offset by other features, such as averaging, or a point-to-point indexing method. On the other hand, an insurance company may offset a lower participation rate by also offering a feature such as an annual reset indexing method.

E. Minimum guaranteed interest rate

**MINIMUM GUARANTEED INTEREST RATE**

Minimum guaranteed interest rates afford seniors a greater peace of mind when purchasing an annuity. The equity-indexed annuity, like other fixed annuities, also promises to pay a minimum interest rate. The rate that will be applied will not be less than this minimum guaranteed rate even if the index-linked interest rate is lower. The value of the annuity will never drop below a guaranteed minimum. The guaranteed value is the minimum amount available during a term for withdrawals, as well as for some annuitization and death benefits. The insurance company will adjust the value of the annuity at the end of each term to reflect any index increases. With equity-indexed annuities, bonds support the minimum guaranteed rate, but options in an index are purchased to enhance the credited rate. The minimum guaranteed interest rate accumulates separate from index account. At the end of the contract term, the client receives the greater of:

- (a) the minimum guaranteed value or
- (b) the index value.

Not both!

The client receives the greater of these two values when the annuity reaches its term or is surrendered prematurely. A variety of methods are used to calculate the minimum guaranteed interest rate. Usually, it is calculated as a percentage of the premium deposited. Different methods of calculating the minimum guaranteed values produce a variety of results. Agents must understand and be able to explain to clients how these variations impact minimum guaranteed values.

**THE NAIC MODEL FOR MINIMUM GUARANTEED INTEREST RATES**

Some companies are now using the NAIC's Interest-Indexed Annuity Contract Model Regulation as the method for setting the minimum guaranteed interest rates. Since the State of California has adopted this model in Section 10168.25 of the California Insurance Code, agents should be familiar with it.

Under the traditional approach, the guaranteed minimum rate remains constant during the annuity's term. With the NAIC's Model, the minimum guaranteed interest rates can fluctuate within a range each anniversary, based on the interest rates of an external reference. For the insurance company, this approach allows the company to maintain adequate cash flows during times when prevailing interest rates may be low; but for the agent it adds much more complexity to the guaranteed minimum interest rate. Agents who represent contracts using this method should be sure they understand, and can explain to their clients, how this will affect the growth of their annuity.
F. Impact of premature surrender charges

**PREMATURE SURRENDER CHARGES**

Insurance companies who offer deferred annuities impose a penalty for withdrawing funds prematurely, called a surrender charge. Pursuant to Sections 10127.12 and 10127.13, carriers are required to disclose that surrender charges exist on the cover of the policy, in addition to sending statements to the contract owner that illustrate the surrender values.

Surrender charges are assessed to help a company recover costs including commissions in the event a policyholder withdraws the funds prior to the term. There is a direct correlation between commissions and surrender charges: The higher the commission – the higher the surrender charges. Like fixed annuities, the surrender charges in equity-indexed annuities are stated as a percentage and usually vanish over time. When an equity-indexed annuity is surrendered prior to its term, the surrender charge is assessed against the index value and then compared to the minimum guaranteed contractual value. Whichever value is greater becomes the surrender value of the contract. Agents should carefully evaluate the death benefit provision when recommending equity-indexed annuities to a senior. Some products assess a surrender charge at death unless the beneficiary agrees to take the proceeds over a 5-year period. This difference can be dramatic especially for beneficiaries who may need the funds in the annuity right away to pay for obligations of the deceased. Agents should make sure they understand the liquidity provisions of the equity-indexed annuities they sell. Some equity-indexed annuities offer no access to cash values during the policy term, which may last for several years. Others may offer only limited access, while some offer withdrawals on a basis similar to other fixed annuities.

1. Two-tier annuities - define concepts

**Two-Tiered Annuities**

A Two-Tiered Annuity is an annuity which retroactively credits a lower rate of interest on accumulated values if the contract is surrendered rather than annuitized.

Two-tiered annuities offer relatively high rates, but only if the owner holds the contract for a certain number of years and then annuitizes it. If the annuity is surrendered at any point, interest credited to the contract is recalculated from the contract's inception using a lower tier of rates. The contract owner gets one tier of interest rates by staying with the contract through annuitization and another, lower tier of rates if he or she does not. These products are used most often in the tax-sheltered annuity market with teachers. Agents who sell two-tiered annuities must make sure that clients know how the product works and are prepared to commit themselves and their beneficiaries to the annuity for a long term.

G. Charges and fees

**EQUITY INDEXED ANNUITY CHARGES & FEES**

EIAs are long-term investments. Getting out early may mean taking a loss. Many EIAs have surrender charges. The surrender charge can be a percentage of the amount withdrawn or a reduction in the interest rate credited to the EIA.

Agents should determine what surrender charges may apply and how long the surrender charge period lasts in relation to the indexing period. Often, surrender charges apply for the length of the policy term, at which point there is a "window" during which the owner can withdraw the annuity funds or renew the annuity for another term at the participation percentage declared by the company for that term. In addition to the surrender and withdrawal charges and free withdrawals, there are additional considerations for
equity-indexed annuities. Some annuities credit none of the index-linked interest or only part of it if clients take out money before the end of the term. The percentage that is vested, or credited, generally increases as the term comes closer to its end and is always 100% at the end of the term. Also, any withdrawals from tax-deferred annuities before clients reach the age of 59½ are generally subject to a 10% tax penalty in addition to any gain being taxed as ordinary income.
VII. Identify and discuss available riders

Annuity Riders

Insurers have developed a variety of riders adding additional features to make annuities more appealing to consumers. The riders discussed in this course are Life Insurance Riders, Long-Term Care Riders, and Guaranteed Monthly Income Benefit Riders. Many other riders may be available.

F. 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.

A. Life insurance riders

LIFE INSURANCE RIDERS

Life insurance riders help beneficiaries offset the income tax due on annuity gains. They are especially suitable for seniors who purchase annuities with no intent to access the funds, but want the proceeds passed on to children and grandchildren upon their death. The death benefit can increase based on increases in the account value. Typically, this is measured by recording the highest value on any contract annivary.

Under this option, an increasing term rider is attached to the annuity contract. As the annuity credits its interest rates, some portion of the account value increases are withdrawn to apply as premiums on the ever increasing amount of term insurance. At the annuity owner's death, the beneficiary receives, tax free (or tax reduced) the death benefit from the annuity plus that from the term rider. Because the annuity's benefit is equal (or close to) to the amount of the original principal, there is no taxable gain. The term rider pays income tax free death benefits.

Income taxes are payable on amounts withdrawn from the annuity to pay the insurance premiums. However, these amounts are minor compared to what beneficiaries would pay were they to receive the traditional gain from the annuity.

B. Long term care benefits riders

LTC riders on annuity contracts are usually more limited than conventional LTC policies on the market today and may also be subject to different, often stricter, coverage triggers. When working with seniors, a number of factors should be considered when evaluating annuities with LTC riders. Non-medically underwritten riders cannot be accessed until the contract has been in force long enough to protect the carrier from the affects of adverse selection, commonly five to seven years.

- With a non-medically underwritten rider your client's life expectancy should be longer than the waiting period on the rider or the rider may not be suitable since the likelihood of accessing benefits diminishes.
• If your client is considering an annuity with a LTC rider in place of conventional long-term care insurance, take the time to explain the differences between the two. LTC riders should not be sold as substitutes for LTC policies.
• These riders do not participate in California's Partnership for Long-Term Care Program. Clients who purchase an annuity with a long-term care rider will not be eligible for expanded asset protection from Medi-Cal, as well as other consumer safeguards in a Partnership Policy. For more information: www.dhs.ca.gov/cpltc

1. Terms of riders

Terms of Riders

These riders are designed to provide benefits over and above the monthly payments received from an annuity. 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 the contract definitions.

There are generally two types of long-term care riders - underwritten and non underwritten. Underwritten riders typically offer richer benefits closer to those found in stand-alone LTC policies than non-underwritten riders.

Medically Underwritten Long-Term Care Riders

When a claim occurs, the insured's annuity value is used to fund qualified LTC expenses. Most underwritten riders require the annuity's value to be completely used up before access to the rider's benefit can begin. Once the annuity value has been depleted, the rider continues paying for LTC expenses, subject to the maximum benefit of the rider. Underwritten riders, similar to conventional long-term care insurance, require detailed applications and face-to-face assessments to establish acceptability. Underwritten riders also utilize industry standard policy provisions and definitions such as benefit triggers, elimination periods, benefit maximums and inflation protection.

The long-term care provisions of the policy are generally triggered by a physician's certification that the insured is chronically ill and unable to perform a specified number of daily living activities. The long-term care provided may involve a deductible period, but it can be defined to cover care in an assisted living facility or home health care as well as confinement in a nursing home. LTC riders also cover both Alzheimer’s Disease and similar forms of irreversible mental impairment.

Non-medically Underwritten Long-Term Care Riders

Non-medically underwritten long-term care riders are more limited in the scope of benefits they contain, but they appeal to consumers who cannot purchase medically underwritten long-term care insurance due to medical conditions. With annuities that offer non-medically underwritten riders, a cost for the rider is deducted from the annuity's cash value to create a separate fund for long-term care expenses. Funds withdrawn from the long-term care fund do not deplete the annuity account. Provided the insured meets the benefit triggers and satisfies the elimination period (if any), a percentage of the long-term care account may be accessed. Benefits are usually further limited by a maximum benefit period.

2. Differentiate between crisis waivers and long term care riders

LTC RIDERS COMPARED TO CRISIS WAIVERS

Long-term care insurance riders are different than crisis waivers. An annuity containing a long-term care insurance rider provides separate insurance benefits which cover expenses across the long-term care
continuum including nursing home care, assisted living facility care, home and community-based care. A nursing home crisis waiver merely eliminates surrender charges upon withdrawal of funds from the annuity in the event a nursing home admission occurs after the annuity was purchased. No insurance benefit is provided, and the crisis waiver does not apply to all aspects of the long-term care continuum such as home care, assisted living or adult day care.

In California, agents who sell long-term care insurance policies, including life insurance and annuity contracts containing long-term care insurance riders, are required to complete additional training as a prerequisite. Agents selling policies with LTC waivers would not be required to take this special training.

C. Skilled nursing facility rider

Skilled Nursing Facility Rider

A rider that adds skilled nursing facility benefits to the contract. The term "skilled nursing facility" refers to the level of skilled medical care required. Medicare.gov defines the term as; "A nursing facility with the staff and equipment to give skilled nursing care and, in most cases, skilled rehabilitative services and other related health services."

The California Health and Safety Code defines the term like this; "Skilled nursing facility" means a health facility that provides skilled nursing care and supportive care to patients whose primary need is for availability of skilled nursing care on an extended basis (California Health and Safety Code Sec. 1250).

The greater of the Annuity Value, including any indexed earnings up to the date of death, or the surrender value will be paid at the death of the owner.

D. Hospice rider

Hospice Rider

This type of policy rider would offer hospice care, which is delivered in a person's home, or in a homelike setting. It is designed to meet the physical, emotional, and spiritual needs of those who are nearing death. Hospice care includes pain management, and focuses on working with the dying person's immediate family, the clergy, and the person's medical care providers.

When the contract owner is confined to a licensed hospital, licensed convalescent care facility, skilled nursing facility, custodial care facility, or licensed hospice facility for 60 or more consecutive days.

E. Loan provisions

LOAN PROVISIONS

Loan provisions are another means to access annuity funds. Loans on these annuities receive preferred tax treatment as well if they are structured and paid back according to IRS guidelines. Though loan provisions are usually found in most qualified annuities, some of the newer nonqualified annuities have also incorporated loan provisions. These loans are typically available to contract owners at a low cost. However, annuity loans are considered distributions from annuity contracts and therefore are taxable. If a loan is taken before the annuitant reaches age 59½, a 10 percent early withdrawal penalty also applies.
VIII. Penalties (Section 782, 789.3, 1738.5, 10509.910 et seq. of the CIC)  
(Attachment III)  

10509.910. The purpose of this article is to require insurers to establish a system to supervise recommendations and to set forth standards and procedures for recommendations to consumers that result in transactions involving annuity products, so that the insurance needs and financial objectives of consumers at the time of the transaction are appropriately addressed.

A. Violation of provisions in Section 780 or 781 of the CIC (Section 782 of the CIC)

782. Any person who violates the provisions of Section 780 or 781 is punishable by a fine not exceeding twenty-five thousand dollars ($25,000), or in a case in which the loss of the victim exceeds ten thousand dollars ($10,000), by a fine not exceeding three times the amount of the loss suffered by the victim, by imprisonment in a county jail for a period not to exceed one year, or by both a fine and imprisonment. Restitution to the victim ordered pursuant to Section 1202.4 of the Penal Code must be satisfied before any fine imposed by this section is collected.

780. An insurer or officer or agent thereof, or an insurance broker or solicitor must not cause or permit to be issued, circulated or used, any statement that is known, or should have been known, to be a misrepresentation of the following:

(a) The terms of a policy issued by the insurer or sought to be negotiated by the person making or permitting the misrepresentation.

(b) The benefits or privileges promised thereunder.

(c) The future dividends payable thereunder.

781. (a) A person must not make any statement that is known, or should have been known, to be a misrepresentation

(1) to any other person for the purpose of inducing, or tending to induce, such other person either to take out a policy of insurance, or to refuse to accept a policy issued upon an application therefor and instead take out any policy in another insurer, or

(2) to a policyholder in any insurer for the purpose of inducing or tending to induce him or her to lapse, forfeit or surrender his or her insurance therein.

(b) A person must not make any representation or comparison of insurers or policies to an insured which is misleading, for the purpose of inducing or tending to induce him or her to lapse, forfeit, change or surrender his or her insurance, whether on a temporary or permanent plan.

B. Administrative penalty, amounts, rescission of contracts (Section 789.3 of the CIC)

789.3. (a) Any broker, agent, or other person or other entity engaged in the transactions of insurance, other than an insurer, who violates this article is liable for an administrative penalty of no less than one thousand dollars ($1,000) for the first violation.

(b) Any broker, agent, other person, or other entity engaged in the business of insurance, other than an insurer, who engages in practices prohibited by this article a second or subsequent time or who
commits a **knowing violation** of this article, 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.

(c) If the commissioner brings an action against a **licensee** pursuant to subdivision (a) or (b) and determines 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 the hearing described in subdivision (c) of Section 789.

(d) Any **insurer** who violates this article is liable for an **administrative penalty of ten thousand dollars ($10,000)** for the first violation.

(e) Any **insurer** who violates 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.

(f) The commissioner may require **rescission of any contract found to have been marketed, offered, or issued in violation of this article**.

**C. Allegations of misconduct against a person 65 year or over (Section 1738.5 of the CIC)**

1738.5. A proceeding held pursuant to Section 1668, 1668.5, 1738, 1739, or 12921.8 that involves allegations of misconduct perpetrated against a person age 65 or over must be held **within 90 days** after receipt by the department of the notice of defense, unless a continuance of the hearing is granted by the department or the administrative law judge. When the matter has been set for hearing, only the administrative law judge may grant a continuance of the hearing. The administrative law judge may, but need not, grant a **continuance** of the hearing, **only upon** finding the existence of **one or more of the following**:

(a) The death or incapacitating illness of a party, a representative or attorney of a party, a witness to an essential fact, or of the parent, child, or member of the household of any of these persons, when it is not feasible to substitute another representative, attorney, or witness because of the proximity of the hearing date.

(b) Lack of notice of hearing as provided in Section 11509 of the Government Code.

(c) A material change in the status of the case where a change in the parties or pleadings requires postponement, or an executed settlement or stipulated findings of fact obviate the need for hearing. A partial amendment of the pleadings must not be good cause for continuance to the extent that the unamended portion of the pleadings is ready to be heard.

(d) A stipulation for continuance signed by all parties, or their authorized representatives, that is communicated with the request for continuance to the administrative law judge no later than 25 business days before the hearing.

(e) The substitution of the representative or attorney of a party upon showing that the substitution is required.

(f) The unavailability of a party, representative, or attorney of a party, or witness to an essential fact, due to a conflicting and required appearance in a judicial matter if, when the hearing date was set, the person did not know and could neither anticipate nor at any time avoid the conflict, and the conflict, with the request for continuance, is immediately communicated to the administrative law judge.
(g) The unavailability of a party, a representative or attorney of a party, or a material witness due to an unavoidable emergency.

(h) Failure by a party to comply with a timely discovery request if the continuance request is made by the party who requested the discovery.

D. Administrative penalties (Section 10509.9 of the CIC)

10509.9. (a) Any agent or other person or entity engaged in the business of insurance, other than an insurer, who violates this article is liable for an administrative penalty of no less than one thousand dollars ($1,000) for the first violation.

(b) Any agent or other person or entity engaged in the business of insurance, other than an insurer, who engages in practices prohibited by this chapter a second or subsequent time or who commits a knowing violation of this article, 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.

(c) Any insurer who violates this article is liable for an administrative penalty of ten thousand dollars ($10,000) for the first violation.

(d) Any insurer who violates 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.

(e) After a hearing conducted in accordance with Chapter 4.5 (commencing with Section 11400) and Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code, the commissioner may suspend or revoke the license of any person or entity that violates this article.

(f) Nothing in this section must be deemed to affect any other authority provided by law to the commissioner.

Attachment III – Penalties defined
Penalties Defined (Section 782, 786, 789.3, 1738.5, 10509.910 et seq. of the CIC)

<table>
<thead>
<tr>
<th>California Insurance Code</th>
<th>Violation</th>
<th>Penalty</th>
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| **Section 782** Establishes penalties for violation of section 780 and section 781 | **Section 780** - Prohibited Misrepresentation  
**Section 781** - Twisting (see page 3 for actual language) | Punishable by fine not to exceed $25,000, or if victim loss exceeds $10,000, the fine not to exceed 3 times the loss suffered by the victim, by imprisonment not to exceed 1 year or by both a fine and imprisonment  
Restitution to victim pursuant to Section 1202.4 of the Penal Code shall be satisfied before any fine imposed by this section is collected |
| **Section 786** Provides for an examination period of 30 days after the receipt of the policy or certificate for purposes of review of the contract | no violations or penalties cited in this section (see page 3 for actual language) | |
| **Section 789.3** Administrative penalties; amounts; rescission of contracts | **Section 789.3:**  
(a) and (b) by broker, agent, or other person engaged in the transactions of insurance other than an insurer (see page 4 for actual language)  
(d) and (e) by insurer | 789.3(a) minimum $1,000 for the first violation  
789.3(b) minimum $5,000 and no more than $50,000 each subsequent violation  
789.3(c) Commissioner may suspend or revoke license  
789.3(d) $10,000 for the first violation  
789.3(e) minimum $30,000 and no more than $300,000 each violation thereafter  
789.3(f) Commissioner may require rescission of contract |
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<th>Section 1668.1</th>
<th>Acts that constitute cause to suspend or revoke any permanent license issued pursuant to this chapter</th>
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<td>(a) and (b) by any agent or other person or entity engaged in the business of insurance other than an insurer (see page 6 for actual language)</td>
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<tr>
<td>(c) and (d) by insurer (see page 6 for actual language)</td>
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<tr>
<td>(e) by person or entity after a hearing (see page 6 for actual language)</td>
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| 10509.9 (a) | $1,000 for the first violation |
| 10509.9 (b) | minimum $5,000 and no more than $50,000 each subsequent violation |
| 10509.9 (c) | $10,000 for the first violation |
| 10509.9 (d) | minimum $30,000 and no more than $300,000 each violation thereafter |
| 10509.9 (e) | the Commissioner may suspend or revoke the license |

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<th>Section 10509.916</th>
<th>Insurer responsibilities</th>
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<td>violations and penalties to be determined (see page 7 for actual language)</td>
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Penalties – Eight-Hour Annuity Training, Attachment III
Current Law

This list includes the statutes stated in SB 618 and the penalty statute from AB 689 (Chapter 295, Statutes of 2011) Insurance: annuity transactions, Section 10509.914 of the California Insurance Code, which will take effect on January 1, 2012.

Section 780: An insurer or officer or agent thereof, or an insurance broker or solicitor shall not cause or permit to be issued, circulated or used, any statement that is known, or should have been known, to be a misrepresentation of the following:
(a) The terms of a policy issued by the insurer or sought to be negotiated by the person making or permitting the misrepresentation.
(b) The benefits or privileges promised thereunder.
(c) The future dividends payable thereunder.

Section 781: (a) A person shall not make any statement that is known, or should have been known, to be a misrepresentation (1) to any other person for the purpose of inducing, or tending to induce, such other person either to take out a policy of insurance, or to refuse to accept a policy issued upon an application therefor and instead take out any policy in another insurer, or (2) to a policyholder in any insurer for the purpose of inducing or tending to induce him or her to lapse, forfeit or surrender his or her insurance therein.
(b) A person shall not make any representation or comparison of insurers or policies to an insured which is misleading, for the purpose of inducing or tending to induce him or her to lapse, forfeit, change or surrender his or her insurance, whether on a temporary or permanent plan.

Section 782: Any person who violates the provisions of Section 780 or 781 is punishable by a fine not exceeding twenty-five thousand dollars ($25,000), or in a case in which the loss of the victim exceeds ten thousand dollars ($10,000), by a fine not exceeding three times the amount of the loss suffered by the victim, by imprisonment in a county jail for a period not to exceed one year, or by both a fine and imprisonment. Restitution to the victim ordered pursuant to Section 1202.4 of the Penal Code shall be satisfied before any fine imposed by this section is collected.

Section 786: 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.

a) 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.

b) 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 provided in Section 685.010 of the Code of Civil Procedure. The interest shall be paid from the date the insurer or entity received the returned policy or certificate.
(c) 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.

(d) In the event of any conflict between this section and Section 10127.10 with respect to life insurance, the provisions of Section 10127.10 shall prevail.

Section 789.3:  (a) Any broker, agent, or other person or other entity engaged in the transactions of insurance, other than an insurer, who violates this article is liable for an administrative penalty of no less than one thousand dollars ($1,000) for the first violation.

(b) Any broker, agent, other person, or other entity engaged in the business of insurance, other than an insurer, who engages in practices prohibited by this article a second or subsequent time or who commits a knowing violation of this article, 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.

(c) If the commissioner brings an action against a licensee pursuant to subdivision (a) or (b) and determines 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 the hearing described in subdivision (c) of Section 789.

(d) Any insurer who violates this article is liable for an administrative penalty of ten thousand dollars ($10,000) for the first violation.

(e) Any insurer who violates 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.

(f) The commissioner may require rescission of any contract found to have been marketed, offered, or issued in violation of this article.

Section 1668.1:  (a) 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 listed in subdivision (e).

(b) The licensee has induced a client, whether directly or indirectly, to make the licensee or any of the persons listed in subdivision (e) 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.

(c) 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.

(d) 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.

(e) Subdivisions (a) and (b) shall also apply if the licensee induces the client to provide the benefits in those subdivisions to the following people:

1. A person who is related to the licensee by birth, marriage, or adoption.
2. A person who is a friend or business acquaintance of the licensee.
3. A person who is registered as a domestic partner of the licensee.

(f) This section shall not apply to situations in which the client is:

1. A person related to the licensee by birth, marriage, or adoption.
2. A person who is registered as a domestic partner of the licensee.

Section 1738.5: A proceeding held pursuant to Section 1668, 1668.5, 1738, 1739, or 12921.8 that involves allegations of misconduct perpetrated against a person age 65 or over shall be held within 90 days after receipt by the department of the notice of defense, unless a continuance of the hearing is granted by the department or the administrative law judge. When the matter has been set for hearing, only the administrative law judge may grant a continuance of the hearing. The administrative law judge may, but need not, grant a continuance of the hearing, only upon finding the existence of one or more of the following:

(a) The death or incapacitating illness of a party, a representative or attorney of a party, a witness to an essential fact, or of the parent, child, or member of the household of any of these persons, when it is not feasible to substitute another representative, attorney, or witness because of the proximity of the hearing date.

(b) Lack of notice of hearing as provided in Section 11509 of the Government Code.

(c) A material change in the status of the case where a change in the parties or pleadings requires postponement, or an executed settlement or stipulated findings of fact obviate the need for hearing. A partial amendment of the pleadings shall not be good cause for continuance to the extent that the un-amended portion of the pleadings is ready to be heard.

(d) A stipulation for continuance signed by all parties, or their authorized representatives, that is communicated with the request for continuance to the administrative law judge no later than 25 business days before the hearing.

(e) The substitution of the representative or attorney of a party upon showing that the substitution is required.

(f) The unavailability of a party, representative, or attorney of a party, or witness to an essential fact, due to a conflicting and required appearance in a judicial matter if, when the hearing date was set, the person did not know and could neither anticipate nor at any time avoid the conflict,
and the conflict, with the request for continuance, is immediately communicated to the administrative law judge.

(g) The unavailability of a party, a representative or attorney of a party, or a material witness due to an unavoidable emergency.

(h) Failure by a party to comply with a timely discovery request if the continuance request is made by the party who requested the discovery.

Section 10509.9: (a) Any agent or other person or entity engaged in the business of insurance, other than an insurer, who violates this article is liable for an administrative penalty of no less than one thousand dollars ($1,000) for the first violation.

(b) Any agent or other person or entity engaged in the business of insurance, other than an insurer, who engages in practices prohibited by this chapter a second or subsequent time or who commits a knowing violation of this article, 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.

(c) Any insurer who violates this article is liable for an administrative penalty of ten thousand dollars ($10,000) for the first violation.

(d) Any insurer who violates 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.

(e) After a hearing conducted in accordance with Chapter 4.5 (commencing with Section 11400) and Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code, the commissioner may suspend or revoke the license of any person or entity that violates this article.

(f) Nothing in this section shall be deemed to affect any other authority provided by law to the commissioner.

Section 10509.916: (a) An insurer is responsible for compliance with this article. If a violation occurs, either because of the action or inaction of the insurer or its insurance producer, the commissioner may, in addition to any other available penalties, remedies, or administrative actions, order any or all of the following:

(1) An insurer to take reasonably appropriate corrective action for any consumer harmed by the insurer's, or by its insurance producer's, violation of this article.

(2) A managing general agent or an insurance producer to take reasonably appropriate corrective action for any consumer harmed by the insurance producer's violation of this article.

(3) Penalties and sanctions pursuant to Section 10509.9. For purposes of Section 10509.9, this article shall be deemed to be part of Article 8 (commencing with Section 10509), and the
commissioner may in a single enforcement action seek penalties for a first and a second or subsequent violation.