Testimony of Tung Chan
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CPC Committee
SB 1066
Attachment

ATTACHMENT

LEGAL HARM TO CONSUMERS SHOULD "VARIABLE ANNUITIES" BE REMOVED FROM DEFINITION OF "SECURITIES"

We would oppose ACLI's proposal to delete "variable annuities" from the definition of "securities" because it would remove these hybrid securities/insurance products from the securities anti-fraud jurisdiction of the securities laws. We believe this would be harmful to consumers since securities anti-fraud measures are meant to deal with the kinds of risk these complex products pose and also since we have the staff resources necessary to police the complaints of sales practice abuses of securities.

This matter was heavily debated in the 2006 legislative session and the matter was defeated then and again in 2007 primarily because of the legislature's concerns that it would weaken protection to the public and that there was no significant registration burden on the industry. Because this is a very complex matter, the legislature asked the LRB to do an extensive review and report on this proposal in 2006 and the extensive 2007 LRB report did not conclude that the dual registration should be removed.

To help focus on the legal implications and harm to the consumer if ACLI's proposal was adopted, below is enumerated some of the deficiencies in consumer protection that would result. If "variable annuities" were removed from the definition of "securities" and annuities regulation under insurance law were the sole enforcement provisions, there would be the following gaps in consumer protection.

- **Scope –**
    - **Deficiency:** Without securities regulations, consumers would be left with the annuities regulation that currently only covers agents, and not insurers, unless no agent is involved in a recommendation. This insulates the vast majority of insurance companies from liability under the statute as long as an agent is involved. *See* HRS 431:10D-623.
    - **What this means:** Most seniors are sold the product by agents. In those cases, the senior victims may not be able to recover money since the scope limits responsibility to agents who often will not have funds. Insurance companies with the deep pockets are off the hook in these cases which would be in 99% of all cases.
    - **How securities regulation helps fill the gap:** The securities regulators can go after both agent and firm at the same time.
- **Exclusions –**
    - **Deficiency:** Without securities regulations, the annuities regulation does not cover variable annuities that are used to fund pension plans, 401(k)'s, 403(b)'s and other retirement plans. See Section HRS 431:10D-621.
    - **What this means:** Variable annuities sold to seniors investing through pension plans, 401(k)'s, 403(b)'s and other plans would be excluded from the annuities regulation. If ACLI's amendment goes through, the annuity regulation would not include suitability or sales practice abuses in the sale of variable annuities that are bought through pension plans, 401(k)'s,

- 403(b)'s, etc. Our teachers who participate in annuities through 403(b) plans would be particularly impacted. This is particularly unfortunate since variable annuities are the kinds of long-term products that may be found in retirement plans.
- **How securities regulation helps fill the gap:** There is no exclusion under securities laws for retirement plans so securities regulators can oversee abusive sales practices of variable annuities even if the variable annuities fund retirement plans.

- **Deficiency:** Without securities enforcement, the annuities regulation carves out direct-response solicitations. See Section HRS 431:10D-621.
- **What this means:** Variable annuities sold to a senior who sees an ad in the paper, calls and buys without discussing her consumer information to the person on the phone would have no protection against the seller under the annuities regulations. By contrast, if this happened now and that product was not suitable for the buyer and was not properly explained to him or her, the securities enforcement staff could go after that seller for sales practice abuses.
- **How securities regulation helps fill the gap:** There is no exclusion under securities laws for solicitations of any kind. Securities regulators can go after the seller and his or her supervisor for the solicitation. Direct-response solicitations do insulate sellers from liability under securities law.

- **Loopholes –**
  - **Deficiency:** Without securities enforcement, the annuities regulation does not apply to situations where the consumer is deemed to have withheld information. *See* HRS 431:10D-623
  - **What this means:** If a senior doesn't want to tell the agent information the agent asks for, then that transaction is carved out from regulation. Basically, agents can avoid liability if a consumer does not want to answer a question. Ask the senior questions he doesn't want to answer. If he doesn't answer, the agent can sell variable annuities but cleared from responsibility and from enforcement of sales practice abuses.
  - **How securities regulation helps fill the gap:** There is no carve out in securities law that places the burden on the consumer in this way to allow agents to avoid responsibility.

  - **Deficiency:** Without securities enforcement, the annuities regulation does not apply to situations where the agent knew or suspected the consumer might be providing inaccurate information. *See* HRS 431:10D-623.
  - **What this means:** This is a very tricky but serious loophole as drafted. If a senior tells the agent his or her suitability information and the senior inflates the information in a way that the agent knows or suspects is untrue, the agent is still allowed to rely solely on what the senior says. The law would create plausible deniability. So for example, if the agent is

a neighbor and knows or suspects the senior is broke but the senior says he is not, the agent can still sell the senior a risky, expensive product based on the information that was given without regard to what the agent knows or suspects is untrue. This is very bad for consumers, especially seniors who might be embarrassed by their financial standings and might lie as matter of pride.

- **How securities regulation helps fill the gap:** Under the current securities laws, there is more protection. If the seller knew or suspected that the information was untrue and the senior was broke, the seller would not be able to shrug off responsibility. A seller cannot just rely on the senior's information. The seller can be liable for reckless disregard of the truth if he or she knew or suspected.

- **Supervision –**
  - **Deficiency:** Without securities enforcement, the annuity regulation allows substantial delegation of the responsibility for making sure that the requirements of the law are observed. *See* HRS 431:10D-623.
  - **What this means:** This means less protection for consumers. Companies/agents can contract out supervision responsibility to a 3rd party. There is no requirement that the 3rd party has to review every sale of variable annuity it is taking responsibility for.
  - **How securities regulation helps fill the gap:** Under current securities law, every variable annuity is reviewed for supervision and suitability.

- **Remedies –**
  - **Deficiency:** Without securities enforcement, the annuity regulation codifies a doctrine of forgiveness, suggesting that upon taking corrective action, a violator should not be subject to further sanctions. *See* HRS 431:10D-624. Moreover, it codifies specifically in the law that penalties can be reduced or even eliminated if the violation was not part of a "pattern or practice."
  - **What this means:** Once there is a violation, the violator can take a number of steps to correct the problem and show that there was no pattern. If they can, then the law codifies that these measures may allow reduction or elimination of penalties. It's not clear that any of those steps would adequately remedy the victim's loss.
  - **How securities regulation helps fill the gap:** By contrast, under the securities law, while these factors may play a part in penalties, it is not codified and gives the enforcement agencies broader scope and discretion in deciding whether to consider these factors as mitigating.
  - **Deficiency:** Without securities regulation, the annuity regulation allows penalties of up to $10,000 per violation.
  - **How securities regulation helps fill the gap:** A violation of securities laws, including fraud and sales practice abuses, allows for penalties of up to $50,000 per violation and up to $100,000 for victims 62 and older.