LOOKING AHEAD to Best Interest Standards for Life and Annuity Sales

By **Susan S. Krawczyk**
Partner, Eversheds Sunderland
and
Cynthia R. Shoss
Partner and Co-Head of Global Insurance, Eversheds Sunderland

With the DOL Fiduciary Rule having been vacated by the 5th circuit court of appeals in 2018, the intense focus across the industry on the federal fiduciary rule has now shifted to state regulators. Of particular impact to the life and annuity industry is the New York Department of Financial Services (DFS) amendment to Regulation 187, renamed, “Suitability and Best Interests in Life Insurance and Annuity Transactions” regulation.

Key changes include:

- A new best interest standard for recommendations, layered on a suitability standard,
- Application to life insurance recommendations as well as annuity recommendations,
- Application to recommendations for certain transactions in in-force contracts,
- Inclusion of recommendations to refrain from a possible transaction, and
- Expansion of supervision requirements for insurers.

The amended regulation takes effect August 1, 2019 for annuities, and February 1, 2020 for life insurance.

Best Interest Standard for Recommendations

Section 224.4 of the amended regulation requires a producer, or insurer if no producer is involved, to act in the best interest of the consumer when making a recommendation. There are three components to demonstrating that a producer (or insurer) acts in the best

LIMRA hosted Susan Krawczyk and Cynthia Shoss to review the implications of New York Regulation 187 during a member webinar. This article presents highlights from that discussion — and members can access the webinar at limra.com.

interest of the consumer in the case of a recommended *sales transaction* (discussed below):

- First, the recommendation must be based on an evaluation of the consumer's relevant suitability information; must reflect the care, skill, prudence, and diligence that a prudent person in like capacity and familiar with such matters would use under the circumstances then prevailing; and must be made with only the consumer's interest being considered. While compensation is permitted (in compliance with New York insurance laws and regulations), the amount of compensation or receipt of an incentive must not influence the recommendation.
- Second, the transaction must be suitable.
- Third, there is a reasonable basis to believe that the consumer has been informed of policy features, the potential consequences of the transaction, both favorable and unfavorable (including any differences in fee-based and commission-based versions); that the consumer would benefit from certain policy features; and that the policy as a whole and any subaccounts, riders, and product enhancements are suitable for the consumer based on the consumer's suitability information.

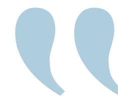
Under Section 224.4, a producer also must have a reasonable basis to believe that a consumer has the financial ability to meet the financial commitments under a recommended sales transaction.

In the case of a recommended *in-force transaction* (discussed below), which is addressed in Section 224.5, a producer is considered to act in the best interest of the consumer if the recommendation reflects the care, skill, prudence, and diligence that a person in like capacity and familiar with such matters would use under the circumstances then prevailing; and is made with only the consumer's interest being considered (the amount of compensation or receipt of an incentive not influencing the recommendation). In addition, there must be a reasonable basis to believe that the consumer has been informed of the relevant contract features and potential consequences of the transaction, both favorable and unfavorable.

Definitions of Recommendation and Transaction

The new best interest requirement highlights the importance of understanding what constitutes a "recommendation" or "transaction" under the amended regulation. Section 224.3 revises the existing definition of recommendation to cover any statement or act by a producer to a consumer that is intended to result in the consumer entering into — or refraining from — a transaction. It also covers a statement

or act that could be interpreted by a consumer to be advice and that results in a transaction in accordance with the advice. "Transaction," in turn, is defined as encompassing both a "sales transaction" and an "in-force transaction." A "sales transaction" means the purchase or replacement of a contract or — in the case of an in-force contract — any conversion, modification, or election of a contractual provision that generates new sales compensation. Notably, new sales compensation does not include compensation paid to a producer when additional premiums or deposits are paid into the policy. An "in-force transaction" is defined as a modification or election of a contractual provision under an in-force contract that does not generate new sales compensation. By implication, a transaction under an in-force contract that does not generate new sales compensation — and is other than a modification or election of a contractual provision — is outside the scope of the amended regulation.



Producers need to be adequately trained in the products and the product transactions that they may recommend to consumers.

Best Interest for Life Insurance

The amended regulation differs from New York's (and other states') existing suitability regulations in that it will apply to life insurance recommendations. In this respect, the amended regulation highlights the need for suitability standards for life insurance. While Section 224.3 specifies the "suitability information" that is to be collected (and in so doing, differentiates between term life insurance with no cash value and all other insurance), it does not provide guidance regarding the standards or considerations to apply to the suitability information so collected. Insurers may want to consider developing standards based on their existing underwriting guidelines, although they may need to understand the basis and purpose of those guidelines. If the guidelines were developed to assess an insurer's risk exposure in taking on the insurance obligation, the guidelines may not be relevant to the question of whether the amount and type of insurance is suitable for the consumer.

Post-Issue Servicing

Under Section 224.6, an insurer has a supervision responsibility only for recommended *sales* transactions, and not for recommended *in-force* transactions, i.e., those post-issue transactions for which there is no sales compensation. Given this, insurers will need to determine which types of post-issue transactions will trigger new sales compensation, and therefore need to be covered by the insurer's supervision system.

Insurer Responsibility for Suitability

Section 224.6 states that an insurer is not to effect a sales transaction unless there is a reasonable basis to believe that the sales transaction is suitable based on the suitability information provided by the consumer. The amended regulation explicitly provides that the insurer need not consider the availability of products, services, and transactions of companies other than the insurer in reaching the reasonable basis requirement. Of note, the amended regulation does not impose a suitability requirement on insurers in the case of in-force transactions. Also, it does not apply to any transaction that was not recommended.

Insurer Supervision Responsibility

Section 224.6 requires an insurer to establish, maintain, and audit a system of supervision to achieve the insurer's and its producers' compliance with the amended regulation. This system must include standards and procedures for the collection of a consumer's suitability information for sales

transactions and must cover the documentation and disclosure of the basis for any sales transaction recommendations. In addition, it must provide for the review of complaints received by the insurer regarding recommendations that are inconsistent with the consumer's best interest. Last, it must provide for auditing and/or contemporaneous review of recommendations to monitor for producer compliance with the regulation in the case of sales transactions.

Third-Party Outsourcing

Section 224.6 permits an insurance company to contract with a third party to establish and maintain a system of supervision for recommendations of sales transactions involving the insurer's products. The amended regulation does not explicitly address delegation of supervision to a third party with regard to in-force transactions as defined in the rule, presumably because the insurer is not responsible for supervising in-force transactions. It may be worth noting, though, that in-force transactions and contracts subject to FINRA rules will need to be supervised by the broker-dealer firm whose producers are engaged in effecting them.

Producer Compensation

The amended regulation addresses producer compensation in several contexts. First, as discussed earlier, a producer (or insurer if no producer is involved) may receive compensation only as permitted under New York insurance laws and regulations, and the amount of compensation or the receipt of an incentive does not influence the recommendation. Second, the producer must inform the consumer of the differences between fee-based and commission-based versions of a contract if both are offered and the manner in which the producer is compensated for the sale and servicing of the contract. (In the case of insurers offering both fee-based and commission-based versions of their products, they must provide consumers a comparison in a form acceptable to the New York insurance superintendent.) Finally, Section 224.6 requires that insurance companies design compensation and incentive practices to avoid producer recommendations that are not in a consumer's best interest.

Wholesalers

Section 224.4 expressly applies the best interest requirements to every producer who materially participates in the making of a sales transaction recommendation and received compensation as a result of the sales transaction, regardless of whether the producer has any direct contact with the consumer. This provision has raised questions about whether the amended regulation, specifically the best interest and suitability requirements, could apply to wholesalers, depending on their interaction (by phone or in person) with consumers, or their involvement in illustrations or suggestions provided to retail producers.

Disclosures and Documentation

The amended regulation imposes disclosure requirements on both producers and insurers. When recommending a sales transaction, producers are required to disclose to the consumer "in a reasonable summary format" all relevant suitability considerations and product information, both favorable and unfavorable, that provide the basis for the recommendation. The basis for the recommendation must also be documented. This is in addition to any disclosure provided to the consumer to satisfy the requirement that the consumer has been "informed" of the policy features. As discussed earlier, producers and insurers must provide disclosures if they offer commission-based and fee-based versions of a product. In addition, "prominent" disclosure must be provided if a producer limits the range of policies recommended based on a captive or affiliation agreement with a particular insurer; the form of this disclosure must be acceptable to the New York insurance superintendent.

Training

The amended regulation imposes two different training requirements. The first, which is in Section 224.4 (and also in 224.5 for in-force transactions), prohibits a producer from making a transaction recommendation about which the producer has inadequate knowledge. Put another way, producers need to be adequately trained in the products and the product transactions (such as conversions, modifications, and elections) that they may recommend to consumers. The second training requirement appears

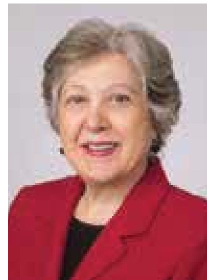
in Section 224.6, the insurer supervision provision. This section makes the insurer responsible for ensuring that every producer recommending a transaction in the insurer's contracts is adequately trained to make the recommendation in accordance with the regulation. This means that the producer is trained to make the recommendation in accordance with the best interest requirement and other requirements of the amended regulation.

Financial Exploitation Prevention

Section 224.6 requires an insurer to establish and maintain procedures designed to prevent financial exploitation and abuse. Financial abuse means the "improper use of an adult's funds, property or resources by another individual." It Includes fraud, false pretenses, embezzlement, conspiracy, forgery, falsifying records, coerced property transfers, or denial of access to assets. Financial exploitation prevention has been on the radar of various state and federal financial regulators for some years. DFS also regulates banks, and has provided some guidance in that context on expectations for preventing elder financial exploitation. Best practices include developing a plan to detect and report suspected elder financial exploitation including using so-called red flag procedures, training employees regularly on the organization's policies and procedures to prevent abuse, and appointing staff to investigate suspected exploitation and to report it.

Looking Forward

The amended New York Regulation 187 significantly expands and enhances the standards and requirements applicable to producers and insurers issuing, selling, or servicing life insurance and annuity contracts delivered or issued for delivery. Because the regulation in New York will likely influence other state regulations, the implications of this for best interest and consumer-centric regulations cannot be overstated. Financial services companies in both the life and annuity spaces may see long-lasting and wide-reaching effects, and they should continue to study this issue as well as encourage producer education regarding this landmark regulation.



Susan S. Krawczyk is a partner with the law firm Eversheds Sutherland (US) LLP. She advises clients regularly on distribution and wholesaling arrangements for both public and private securities offerings and insurance distribution, including incentive, non-cash compensation, and marketing support arrangements. She has particular experience with firms involved in the sale and distribution of insurance and investment products and programs in the registered investment adviser context and retirement plan markets. Currently, Krawczyk assists clients in implementing procedures and processes that will satisfy new and proposed standard of care and best interest requirements under state and federal laws applicable to the distribution of insurance products. She can be reached at susankrawczyk@eversheds-sutherland.com.

Cynthia R. Shoss, co-head of Global Insurance and co-leader of the Eversheds Sutherland (US) LLP's Insurance Transactions and Products practice, is a nationally recognized adviser on insurance regulatory matters, focusing on transformative transactions such as demutualizations, mergers and acquisitions, conversions and other restructurings, and pension risk transfers. She also assists clients with legislation, examinations and investigations, and with compliance, governance, and investment issues. Shoss has counseled clients in the various insurance sectors in the United States and internationally,including life insurance, property/casualty insurance, health insurance, workers' compensation, and reinsurance. She can be reached at cynthiashoss@eversheds-sutherland.com.