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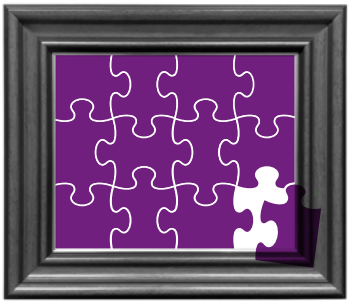

Getting the full picture

The emerging best interest and fiduciary duty patchwork

February 14, 2019

Broker-dealers selling annuities: preparing for the best interest standard under New York's amended Insurance Regulation 187

Broker-dealers selling annuity products in New York will soon need to comply with new best interest requirements imposed by New York's amended Insurance Regulation 187. These requirements, which will take effect for annuities on August 1, 2019, will also impose new documentation, disclosure and training requirements on broker-dealers that sell annuities.

Background. In 2018, the New York State Department of Financial Services (NYDFS) issued a final version of its First Amendment to Insurance Regulation 187, retitled "Suitability and Best Interests in Life Insurance and Annuity Transactions" (Amended Regulation 187).[1] Amended Regulation 187 will impose a best interest standard on recommendations of purchase, replacement and certain other post-issuance transactions involving life insurance[2] and annuity products. According to the NYDFS press release announcing the issuance of the final version of Amended Regulation 187, a goal of the amended regulation is to "fill in regulatory gaps" perceived by NYDFS resulting from the elimination of the federal Department of Labor's Fiduciary Rule.[3]

Summary of Amended Regulation 187. Under Amended Regulation 187, both insurers and producers are subject to new duties and obligations in connection with annuity transactions. These new duties and obligations are layered on top of the existing suitability standard, calling into question whether broker-dealers distributing annuity products in New York can continue to rely on their existing practices and standards under the suitability rules and guidance of the Financial Industry Regulatory Authority, Inc. (FINRA) to establish their substantial compliance with Regulation 187.

In contrast to the US Securities and Exchange Commission's Proposed Regulation Best Interest,[4] Regulation 187 does not apply across-the-board to all broker-dealers. Rather, it applies only to those broker-dealers licensed as insurance producers in the state of New York for the purpose of distributing life and annuity products.[5] Moreover, Regulation 187 applies only when broker-dealers make recommendations to residents of the state of New York involving annuity and life insurance products. To date, the NYDFS has not issued any guidance that would serve to provide additional context and analysis with respect to its scope.

Best Interest Standard for Producers. Amended Regulation 187 will significantly expand the duties and obligations of producers[6] by imposing a best interest standard on recommendations to consumers about

1 *See* 11 N.Y.C.R.R. § 224.
2 A significant aspect of the changes to Regulation 187 is the extension of the applicability of the regulation to life insurance transactions; prior to the recent amendment, it only applied to annuity transactions. Although this legal alert does not specifically discuss Amended Regulation 187's impact on broker-dealers distributing life insurance products in New York, many of the requirements discussed in this alert with respect to annuity distribution will also apply to life insurance distribution. The new requirements as they relate to life insurance distribution will take effect on February 1, 2020.
3 *See* NYDFS Press Release, "DFS Issues Final Life Insurance and Annuity Suitability Best Interests Regulation Protecting Consumers from Conflicts of Interest" (July 18, 2018), *available at:* https://www.dfs.ny.gov/about/press/pr1807181.htm.
4 *See* SEC Release No. 34-83062, "Regulation Best Interest" (Apr. 18, 2018).
5 Some broker-dealers are involved in insurance networking arrangements in which an affiliated company acts as the licensed insurance producer to distribute life and annuity products in New York. In this case, Amended Regulation 187 would apply to the affiliated New York-licensed insurance producer.
6 In the event that a producer is not involved in a sales or in-force transaction, these best interest duties and obligations are the responsibility of the insurer.

annuity contracts. In general, when making a recommendation to a consumer, the producer must act in the "best interest" of the consumer as described in Amended Regulation 187.[7] In this regard, Amended Regulation 187 applies not only to purchase and replacement transactions (as is currently the case under Regulation 187) but also to post-issuance transactions that are conversions or modifications of an in-force policy, or the exercise of a contractual provision under an in-force policy. Further, in the case of post-issuance transactions, the best interest standard differentiates between modifications and contractual exercises that involve sales compensation and those that do not, subjecting the latter to a more limited best interest standard (best interest lite). Notably, insurance producers must also act in the best interest of the consumer with respect to "hold" recommendations or recommendations not to effect a transaction.[8]

Sales Transaction Recommendations. In the case of a sales transaction recommendation—which is defined to include the purchase or replacement of a policy, or any modification of or election of a contractual provision under an in-force policy that generates new sales compensation[9]—the producer is deemed to act in the best interest of the consumer when:

- The producer's recommendation to the consumer is based on an evaluation of the relevant suitability information of the consumer and reflects the care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use under the circumstances then prevailing;
- Only the interests of the consumer are considered in making the recommendation;
- The amount of the producer's compensation or the receipt of an incentive does not influence the recommendation;
- The sales transaction is suitable; and
- There is a reasonable basis to believe that (i) the consumer has been reasonably informed of various features of the policy or contract and the potential consequences of the sales transaction, both favorable and unfavorable; (ii) the consumer would benefit from certain features of the policy or contract; and (iii) the particular policy as a whole and underlying subaccounts, riders and product enhancements, if any, or replacement is suitable.[10] Notably, and in particular, there must be a reasonable basis to believe that the consumer has been informed of any differences in features among fee-based and commission-based versions of the policy, and the manner in which the producer is compensated for the sale and servicing of the policy.[11]

Moreover, at the time of a recommendation of a sales transaction, the producer must 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 any recommendations, and document (i) the basis for any recommendations made; or, (ii) if relevant, the consumer's refusal to provide suitability information; and (iii) that a sales transaction is not recommended if a consumer decides to enter into a sales transaction that is not based on the producer's recommendation.[12]

In-force Recommendations. The best interest lite standard, which applies to a recommendation relating to any modification of or election of a contractual provision under an in-force policy that does not generate new sales compensation,[13] is satisfied when:

- The producer's recommendation to the consumer reflects the care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use under the circumstances then prevailing;
- Only the interests of the consumer are considered in making the recommendation;
- The amount of the producer's compensation or the receipt of an incentive does not influence the recommendation; and
- There is a reasonable basis to believe the consumer has been reasonably informed of the relevant features of the policy or contract and the potential consequences of the in-force transaction, both favorable and unfavorable.[14]

Thus, in the case of in-force transactions (and unlike sales transactions), there is no obligation on a producer to (i) evaluate the consumer's relevant suitability information, (ii) ensure that the transaction is suitable, (iii) have a reasonable basis to believe that the consumer would benefit from certain policy features, or that the policy as a whole, underlying subaccounts, riders and product enhancements, or replacements are suitable for the consumer based on the consumer's suitability information, or (iv) discuss differences in fee-based and commission-based versions of a policy or the manner in which the producer is compensated.

Duties and Obligations for Insurers. Amended Regulation 187 also significantly expands the supervisory obligations of insurers in connection with sales transactions in their annuity contracts. This obligation generally requires that an insurer cannot effectuate a sales transaction involving its policies unless there is a reasonable basis to believe that the sales transaction is suitable based on the suitability information provided by the consumer, although the insurer is not required

7 *See* 11 N.Y.C.R.R. § 224.4(a); 11 N.Y.C.R.R. § 224.5(a).
8 *See* 11 N.Y.C.R.R. § 224.3(e) (defining "recommendation" to include, among other things, statements or acts by a producer to a consumer that reasonably may be interpreted to be advice and that results in a consumer refraining from entering into a transaction in accordance with that advice).
9 *See* 11 N.Y.C.R.R. § 224.3(j).
10 *See* 11 N.Y.C.R.R. § 224.4(b).
11 *See* 11 N.Y.C.R.R. § 224.4(b)(3)(i).
12 *See* 11 N.Y.C.R.R. § 224.4(f).
13 *See* 11 N.Y.C.R.R. § 224.3(k).
14 *See* 11 N.Y.C.R.R. § 224.5(b).

to take into consideration the availability of products, services, and transactions of companies other than the insurer when complying with this obligation.[15] It is important to note that insurers do not have supervisory obligations with respect to in-force transactions.

Amended Regulation 187 will specifically require insurers to:

- Establish, maintain, and audit a system of supervision that is reasonably designed to achieve compliance with the best interest standard of care applicable to sales transactions, including standards and procedures for the collection of a consumer's suitability information with respect to sales transactions involving the insurer's policies, the documentation and disclosure of the basis for any recommendation with respect to sales transactions involving the insurer's policies, the review of complaints received by the insurer regarding recommendations inconsistent with the best interest of the consumer, and the auditing and/or contemporaneous review of recommendations to monitor producers' compliance with the best interest standard as relevant to sales transactions;[16]
- Ensure that every producer recommending any transaction with respect to the insurer's policies is adequately trained to make the recommendation in accordance with Amended Regulation 187's requirements for sales transactions including the best interest standard;[17]
- Establish and maintain procedures designed to prevent financial exploitation and abuse;[18] and
- Provide to the consumer a comparison, in a form acceptable to the superintendent, showing the differences between fee-based and commission-based versions of the same product (to the extent that the insurer offers such different versions of the same product and a producer is authorized to offer them both).[19]

Subcontracting Duties to Third Parties. Notably, Regulation 187 permits insurers to contract with third parties—such as broker-dealers—to establish and maintain a system of supervision for recommendations of sales transactions involving the insurer's policies.[20] Accordingly, broker-dealers can expect insurers to delegate to them supervision system functions required of insurers under Regulation 187.This will require broker-dealers to become well-versed in the obligations imposed upon insurers by Regulation 187. Moreover, these contractual delegations, in tandem with the obligation imposed by Regulation 187 for insurers to audit or engage in contemporaneous review of recommendations to monitor producers' compliance with the best interest standard of care with respect to the insurer's policies, means that broker-dealers can expect ongoing diligence of their practices by insurers to ensure compliance with the relevant requirements.

Practical Considerations

Broker-dealers selling annuity products in New York may wish to consider the following steps as they work toward complying with Amended Regulation 187 by the effective date of August 1, 2019:

- **Assess How Best to Leverage Existing Point-of-Sale Processes to Meet Disclosure and Documentation Requirements.** As noted above, Amended Regulation 187 will impose new disclosure and documentation requirements for annuity sales transactions. In particular, at the time of a sales transaction recommendation, the producer must 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 any recommendations, and document (i) the basis for any recommendations made; or, (ii) if relevant, the consumer's refusal to provide suitability information; and (iii) that a sales transaction is not recommended if a consumer decides to enter into a sales transaction that is not based on the producer's recommendation. Point-of-sale documents, such as suitability forms currently in use, may include a standardized statement above the consumer's and/or the producer's signature about their respective belief that the annuity being applied for is suitable for the consumer based on the information collected. Consideration may be given to whether this field in the form may be expanded by the broker-dealer to provide the consumer with disclosure of the relevant suitability considerations and product information, and together with a signed acknowledgment, serve the additional purpose of documenting the basis for the recommendation.
- **Assess Whether Intake Forms Require Revision.** Broker-dealer intake forms used for the purpose of collecting suitability information may need to be revised or expanded to account for the new suitability information producers are required to collect from consumers pursuant to Amended Regulation 187.
- **Assess How Best to Leverage Existing Processes for "Hold" Recommendations.** Many broker-dealers have existing processes for documenting "hold" recommendations that were developed to comply with FINRA requirements in this regard. Firms may want to consider whether these documentation processes can be leveraged to satisfy Amended Regulation 187's

15 *See* 11 N.Y.C.R.R. § 224.6(a).
16 *See* 11 N.Y.C.R.R. § 224.6(b)(1). With respect to the obligation to engage in auditing and/or contemporaneous review, insurers are permitted to use a reasonable risk-based approach to audit and/or contemporaneously review producers' recommendations to identify recommendations of the greatest risk of violation of the best interest standard of care, so long as the approach does not focus solely on recommendations posing the greatest risk with no auditing or review of other recommendations. See 11 N.Y.C.R.R. § 224.6(b)(1)(iv).
17 *See* 11 N.Y.C.R.R. § 224.6(e).
18 *See* 11 N.Y.C.R.R. § 224.6(f).
19 *See* 11 N.Y.C.R.R. § 224.6(h).
20 *See* 11 N.Y.C.R.R. § 224.6(c).

requirement to act in the best interest of the consumer with respect to "hold" recommendations or recommendations not to effect a transaction, such as a recommendation that a consumer not surrender a policy.

- **Assess How Best to Leverage Existing Supervisory Processes Concerning Consumer's Financial Ability.** Amended Regulation 187 prohibits a producer from making a sales transaction recommendation unless there is a reasonable basis to believe that the consumer has the financial ability to meet the financial commitments under the policy.[21] A similar requirement exists under FINRA rules,[22] so firms may want to consider whether existing processes can be leveraged to comply with the new consumer financial ability requirement under Amended Regulation 187.
- **Review Allocation of Responsibilities between Broker-Dealers and Insurance Carriers as Set Forth in Selling Agreements.** As explained above, Amended Regulation 187 permits insurers to contract with third parties—such as broker-dealers—to establish and maintain a system of supervision for recommendations of sales transactions involving the insurer's policies. Given the new requirements, broker-dealers and insurers will want to begin a dialogue to collaboratively reach an understanding of which party will be accountable for satisfying the various obligations under Amended Regulation 187, including the system of supervision required to be established, maintained and audited pursuant to section 224.6(b)(1).
- **Review Special Provisions in Regulation 187 with Respect to Fee-Based Annuities.** If a broker-dealer distributes products for a carrier offering both a fee-based and a commission-based version of the same product, the broker-dealer will need to have a reasonable basis to believe that the consumer has been informed of any differences in features among such different versions. Accordingly, broker-dealers may want to consider reaching out to their carrier partners to determine which of them offer both a fee-based and a commission-based version of the same product and, if so, discuss with the insurer the process for ensuring that consumers receive the necessary comparison forms.
- **Assess Training Needs.** Amended Regulation 187 will impose on insurers the responsibility to ensure that every producer recommending any transaction with respect to the insurer's policies is adequately trained to make recommendations in accordance with the best interest standard of care. Accordingly, broker-dealers may wish to reach out to their carrier partners to determine the training they have planned and, if possible, work with the carrier to ensure that the training meets any specific needs of the broker-dealer or its sales force.

21 *See* 11 N.Y.C.R.R. § 224.4(g).
22 *See* FINRA Supplementary Material 2111.06.

Contacts

For more commentary and resources regarding the emerging landscape related to the standards of conduct for investment professionals, visit Eversheds Sutherland's www.secfiduciaryrule.com.

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