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EXCERPT

New York DFS "Best Interest" Standard for All Life Insurance Products Goes Into Effect While the SEC and NAIC Adopt Rules Addressing Specific Segments of the Market

As discussed in our 2018 Year in Review, on July 17, 2018, Superintendent Maria T. Vullo of the New York State Department of Financial Services (the "**New York DFS**") promulgated a new "best interest" regulation as a replacement for New York's preexisting annuity suitability regulation (Insurance Regulation 187, Part 224 of Title 11 of the New York Compilation of Codes, Rules and Regulations). Titled "Suitability and Best Interests in Life Insurance and Annuity Transactions," the new regulation establishes a "best interest" standard for all sales of life insurance and annuity products. A transaction is considered in the best interest of a consumer when it is in furtherance of a consumer's needs and objectives and only the interests of the consumer are considered in making the recommendation. The regulation also requires insurance companies to establish standards and procedures to supervise recommendations by agents and brokers to consumers with respect to life insurance policies and annuity contracts issued in New York.

The National Association of Insurance and Financial Advisors – New York State filed a lawsuit challenging the regulation in November 2018. That lawsuit was dismissed on August 1, 2019, clearing the way for the best interest standard to go into effect.

Insurers and producers were required to comply with the new rule beginning on August 1, 2019 for annuity sales and February 1, 2020 for life insurance sales.

Since it was first proposed in December 2017, the New York "best interest" regulation has been viewed as a way to fill the vacuum created by the delay and demise of the US Department of Labor "**Fiduciary Rule**" defining who is a "fiduciary" of an employee benefit plan under section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974 as a result of giving investment advice. The Obama administration's Fiduciary rule was scrapped through a combination of court challenges and Trump administration maneuvering in 2018. Unlike the Fiduciary Rule, the New York regulation applies to recommendations outside of retirement accounts and to the sale of all life insurance products (with limited exceptions) but not to mutual funds or other securities.

Meanwhile, on June 5, 2019, the US Securities and Exchange Commission ("**SEC**") finalized its own Regulation Best Interest or "**Regulation BI**" with a compliance date of June 30, 2020. Regulation BI is only applicable to insurance products that are variable and therefore concurrently regulated by state insurance departments and the SEC. Under the new rule a broker-dealer is required to act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. Broker-dealers are currently subject to suitability standards when recommending investment products to clients. Regulation Best Interest also reaffirmed and, in some cases, clarified the SEC's views of the fiduciary duty that investment advisers owe to their clients. As a fiduciary, an investment adviser must act in the best interest of its client. This fiduciary obligation, which includes an affirmative duty of utmost good faith and full and fair disclosure of all material facts, is established under federal law, and the SEC believes that an adviser's fiduciary duty serves as a key component to the SEC's investor protection efforts.

On September 9, 2019, the states of New York, California, Connecticut, Delaware, Maine, New Mexico and Oregon and the District of Columbia filed a complaint for declaratory and injunctive relief against the SEC challenging Regulation BI. The lawsuit led by the New York State Attorney General alleges that the SEC failed to adopt the investor protections required by Dodd-Frank, instead promulgating a "watered down" rule that fails to address broker-dealer conflicts of interest and will increase investor confusion. On September 10, 2019, XY Planning Network, a coalition of fee-only financial planners, filed a similar suit against the SEC. The organization claimed that Regulation BI puts investment advisers at a competitive disadvantage to broker-dealers and makes it more difficult to differentiate an investment adviser's fiduciary standard of conduct from the lower standard of conduct applicable to broker-dealers. Both lawsuits are still pending.

Finally, at the tail end of 2019, the NAIC Life Insurance and Annuities (A) Committee voted to approve its revised Suitability in Annuity Transactions Model Regulation (the "**Revised NAIC Model**") during a conference call, and the full NAIC adopted the revision on February 13, 2020. New York DFS Superintendent Linda Lacewell (who took over from Maria Vullo in early 2019) voted against the revision. The new model requires insurance producers to "act in the best interest of the consumer when making a recommendation of an annuity."

In extending its scope to include sales of life insurance as well as annuity products, the New York regulation goes farther than Regulation BI or the Revised NAIC Model.

Moreover, each of the regulations defines "best interest" differently. The Revised NAIC Model defines "best interest" as "acting with reasonable diligence, care, skill and prudence in a manner that puts the interest of the consumer first and foremost." Regulation BI does not specifically define "best interest" and instead takes what SEC Chair Jay Clayton has called a more "principles-based" approach (although the release adopting Regulation BI runs to 771 pages).

The New York definition of best interest is much more prescriptive:

> The producer, or insurer where no producer is involved, acts in the best interest of the consumer when:
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> (1) the producer's or insurer'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 shall be considered in making the recommendation. The producer's receipt of compensation or other incentives permitted by the Insurance Law and the Insurance Regulations is permitted by this requirement provided that the amount of the compensation or the receipt of an incentive does not influence the recommendation;
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> (2) the sales transaction is suitable; and
>
> (3) there is a reasonable basis to believe:
>
> > (i) the consumer has been reasonably informed of various features of the policy and potential consequences of the sales transaction, both favorable and unfavorable, such as the potential surrender period and surrender charge, any secondary guarantee period, equity-index features, availability of cash value, potential tax implications if the consumer sells, modifies, surrenders, lapses or annuitizes the policy, death benefit, mortality and expense fees, cost of insurance charges, investment advisory fees, policy exclusions or restrictions, potential charges for and features of riders, limitations on interest returns,

guaranteed interest rates, insurance and investment components, market risk, 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 in accordance with Part 30 of this Title (Insurance Regulation 194) and Insurance Law section 2119;

(ii) the consumer would benefit from certain features of the policy, such as tax-deferred growth of any cash values, annuitization, or death or living benefit;

(iii) the particular policy as a whole, the underlying subaccounts to which funds are allocated at the time of the sales transaction, and riders and similar product enhancements, if any, are suitable for the particular consumer based on the consumer's suitability information; and

(iv) in the case of a replacement of a policy, the replacement is suitable including taking into consideration whether:

(a) the consumer will incur a surrender charge, increased premium or fees, decreased coverage duration, decreased death benefit or income amount, adverse change in health rating, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living or other contractual benefits), be subject to tax implications if the consumer surrenders or borrows from the policy, or be subject to increased fees, investment advisory fees, premium loads or charges for riders and similar product enhancements;

(b) the consumer would benefit from policy enhancements and improvements, such as a decreased premium or fees, increased coverage duration, increased death benefit or income amount; and

(c) the consumer has had another policy replacement, in particular, a replacement within the preceding 36 months.[1]

The New York regulation also sets out specific disclosure requirements relating to situations where an insurer has different versions of a product for commission-based versus fee only sales and for captive agents, and the New York DFS issued granular guidance about those requirements on May 29, September 6 and September 11, 2019 and additional FAQs about the regulation as a whole as recently as February 12, 2020.

Regulation BI is divided into a series of "obligations" that the broker-dealer must meet: a General Obligation, a Disclosure Obligation, a Care Obligation, a Conflict of Interest Obligation and a Compliance Obligation (see our prior Legal Update). Broker-dealers and registered investment advisers also must provide a "relationship summary" dubbed Form CRS to every person to whom a recommendation is made. Form CRS is intended to be a plain language description of the relationship with the investor in a Q&A format that also includes information about any disciplinary actions against the broker-dealer or investment adviser.

Now that all three best interest standards are in place, insurers and producers are faced with the compliance challenge of harmonizing the varying requirements across different products (life versus annuities, variable versus non-variable) and distributions channels (broker-dealers versus investment advisers, captive agents versus brokers and independent producers). The Revised NAIC Model does include "safe harbor" provision stating that "Recommendations and sales of annuities made in compliance with comparable standards shall satisfy the requirements under this regulation." Thus, compliance with Regulation BI or New York Regulation 187 should satisfy the requirements of the Revised NAIC Model in any state that adopts it.

[1] 11 NYCRR 224.4(b).

Authors

Lawrence Hamilton
Partner
lhamilton@mayerbrown.com
Chicago
+1 312 701 7055

Sanjiv Tata
Partner
stata@mayerbrown.com
New York
+1 212 506 2205

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