cefli | COMPLIANCE & ETHICS FORUM FOR LIFE INSURERS

Agenda

CEFLI Compliance & Ethics Committee Meeting
Wednesday, June 17, 2020
2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
Dial In: (800) 239-9838
Passcode: 5690858

I. Welcome and Introduction. **Donald J. Walters**

A. Antitrust Statement.

II. Approval of Minutes – May 13, 2020 Meeting. **The Committee**

III. Issues for Review. **The Committee**

A. Coronavirus (COVID-19).

CEFLI's COVID-19 Networking Forum continues to meet every two weeks to explore various compliance-related issues associated with the COVID-19 pandemic. Our thanks to various members of the COVID-19 Networking Forum including Chad Eslinger of Voya Financial, Jason Brassard of American National and Laura Bullard of Foresters for their willingness to serve as moderators for our recent Networking Forum discussions.

The next meeting of the COVID-19 Networking Forum is scheduled to take place on Thursday, June 18 at 3 PM EDT. Please contact Nancy Perez (NancyPerez@cefli.org) to let us know if you or your colleagues may be interested in participating in the COVID-19 Networking Forum.

Members of the Networking Forum have raised a variety of different issues for discussion. Recent questions have pertained to issues associated with the issuance of bulletins by various jurisdictions establishing a moratorium on cancellation of policies for non-payment of premium and the operational issues that may arise accordingly. For example, it is unclear whether companies may be sending out new grace/lapse notices in light of these bulletins. Moreover, some companies have systems that are programmed to automatically send out grace/lapse notices on a state-by-state level and there is limited guidance concerning how to proceed in the future as more states "open up" and rescind their previously issued bulletins.

The Networking Forum also continues to discuss “return to work” strategies to allow individuals who may have been working from home to return to the office to support their normal pre-COVID-19 routines.

CEFLI Affiliate Member Wolters Kluwer provides a free daily email that outlines significant COVID-19 related regulatory changes. For those who may be interested, the link to sign up is: http://www.wolterskluwerfs.com/COVID-19-updates.aspx?wkcid=20.04_AM_CS_EN_WKFS_RCM

The Committee will be asked to discuss current compliance challenges associated with issues arising out of the COVID-19 pandemic. Also, the Committee will be asked to discuss whether their companies have announced plans regarding “return to work” strategies over the weeks and months ahead.

B. Notice - Decrease in Credited Interest Rate - Universal Life Policies.

In 2019, the Texas Legislature passed HB 207 which included provisions requiring companies to provide notice to insureds when the credited interest rate on a universal life insurance policy may decrease. (See copy attached.)

Section 1101.205 (as highlighted) identifies the requirements of the written notice to the policy owner required under Texas law.

A question has been presented concerning the manner in which life insurers may be providing the required notice under Section 1101.205 of HB 207. Specifically:

- *Will your company incorporate the information required in the notice as part of their annual statements?*
- *Will your company create a new notice to be included along with the annual statement?*
- *Will your company create a separate notice that will be sent to the policy owner before/after the annual statement?*
- *Or, is your company considering a different strategy to provide the required notice to the policy owner?*

The Committee will be asked to discuss their strategies with respect to providing the required notice under Texas law to inform policy owners of a decrease in the credited interest rate on a universal life insurance policy.

C. Anti-Money-Laundering - Policy Withdrawals, Loans and Surrenders.

Life insurers are required to monitor policy/contract transactions to determine whether potential anti-money-laundering issues may arise that may require the life insurer to submit Suspicious Activity Reports (SARs) to FinCEN.

Under the terms of many life insurance company products, policyowners have the right to request large withdrawals or loans from their policy/contract or may elect to surrender their policy/contract for its surrender value. In these instances, insurers may not know the reason why a policyholder may request such a transaction thereby making it difficult to determine whether a given transaction is suspicious.

The Committee will be asked to discuss their company strategies related to AML transaction monitoring efforts specific to policy withdrawals, loans and surrenders and will be asked to share insight regarding the information they request from policyowners at the time such transactions are requested.

D. Advertising Review Processes.

Insurance regulators require the review and approval of an insurance company's advertising materials prior to use of such materials. Some insurance companies conduct their advertising materials reviews in-house, while other insurers rely on the services of a vendor or outside consultant to conduct advertising materials reviews on the insurer's behalf.

While practices related to advertising review may differ from company to company, we are interested in determining whether companies require in-house counsel to review advertising materials as part of their review process and also maintain an interest in learning about the experiences of companies that may have elected to use third-party organizations for purposes of conducting advertising reviews.

The Committee will be asked to discuss the extent to which companies require in-house counsel to review advertising materials as part of the review process. The Committee also will be asked to discuss the extent to which their companies contract with a third party for purposes of conducting advertising reviews and, if so, they will be asked to share their experience with such processes and any lessons learned from pursuing such a strategy.

E. Gifts & Entertainment.

Most life insurance companies have policies related to Gifts & Entertainment. Also, some regulatory authorities, such as FINRA, have rules pertaining to Gifts & Entertainment as well.

Several questions related to corporate policies pertaining to Gifts & Entertainment have been submitted for review, including:

- *Does your company limit the dollar amount of gifts (e.g., not to exceed $100) received from third parties?*
- *Is entertainment considered a gift?*
- *Is there a different limit on the value of entertainment (versus a gift)?*
- *Does your company allow exceptions to its Gifts & Entertainment policy?*
- *If approval for exceptions is required, is the approval provided by the Chief Compliance Officer or a delegate?*
- *Are employees required to log gifts received/given?*
- *If so, how is this tracked/reviewed?*

The Committee will be asked to discuss their company's policies with respect to Gifts & Entertainment.

F. *Patronis v. United insurance Company of America, et al*.

In 2016, several life insurance companies challenge the retroactive application of three 2016 amendments to the Florida Disposition of Unclaimed Property Act. In 2018, a trial court decision ruled in favor of the life insurance companies.

However, on June 3, 2020, Florida's First District Court of Appeal issued a decision in *Patronis v. United Insurance Company of America, et al*. thereby reversing the 2018 trial court decision and ruling that the 2016 amendments may operate retroactively. (See copy attached.)

The First District Ct. of Appeal's decision becomes final on June 18. The insurers may request a rehearing or a rehearing en banc or may seek review of the decision in the Florida Supreme Court.

The Committee will be asked to discuss the implications of the decision in Patronis v. United Insurance Company of America, et al. for their unclaimed property practices in the state of Florida going forward.

IV. Reporting Items. **CEFLI Staff.**

A. Arizona Becomes Second State to Adopt Revisions to NAIC Suitability in Annuity Transactions Model Regulation.

Arizona Governor Doug Ducey recently signed Senate Bill 1557 which inaction to law Arizona's version of the recent revisions to the NAIC Suitability in Annuity Transactions Model Regulation. (See copy attached.)

Arizona becomes the second State (following Iowa) to adopt the recent revisions to the NAIC Suitability in Annuity Transactions Model Regulation. The effective date of the Arizona law is December 31, 2020.

B. FINRA Regulatory Notice 20-16 - Transition/Supervision Practices in a Remote Work Environment.

FINRA recently issued Reg of Tori Notice 20-16 to share common themes FINRA observed through discussions with small, midsize and large firms about the steps they reported taking to transition and supervise their employees in a remote work environment. (See copy attached.)

The information may be helpful to life insurers as they evaluate their practices regarding work at home arrangements and explore ways to enhance their supervisory systems and compliance programs.

C. SEC Regulation Best Interest Lawsuits.

Media reports suggested that the judges hearing oral arguments in the US Court of Appeals for the Second Circuit on Tuesday, June 2 appeared to be skeptical of arguments in consolidated lawsuits suggesting that the SEC exceeded its authority by issuing Regulation Best Interest.

It is likely that the Second Circuit may issue a ruling on the expedited hearing prior to the June 30 effective date for implementation of Regulation Best Interest.

D. DOL Fiduciary Rule Sent to OMB for Review.

The US Department of Labor (DOL) sent its revised Fiduciary Rule designed to align with the SEC's Regulation Best Interest to the Office of Management and Budget (OMB) for review.

Media reports suggest that the revised Fiduciary Rule may comprise a prohibited transaction exemption intended to replace the Best Interest Contract Exemption in the prior version of the Rule that was vacated by the Fifth Circuit Court of Appeals. The revised Fiduciary Rule may be designed to cover advisers who are not covered by the SEC's Regulation Best Interest.

E. Rhode Island and Oklahoma Will Require State-Registered Advisers to Attach Form CRS.

Most state securities regulators are not requiring advisors to attach Form CRS (which was issued in conjunction with the SEC's rulemaking package relative to Regulation Best Interest). However, two states, Rhode Island and Oklahoma will require state-registered advisors to attach Form CRS to their Form ADV Part 2.

F. FINRA Report - Artificial Intelligence in the Securities Industry.

FINRA just recently issued a report regarding how artificial intelligence technologies transforming the financial services industry. (See copy attached.)

While the report focuses attention on the use of artificial intelligence in the securities industry, the concepts identified within the report may have application more broadly across the financial services industry.

V. CEFLI Activities.

A. Joint Webinar - *Compliance's Role in Adapting to the New Business as Usual - Balancing Oversight with Agility* - CEFLI/Guidehouse (formerly Navigant) - Wednesday, June 10 - 1 PM EDT/12 Noon CDT/11 AM MDT/10 AM PDT.

CEFLI recently conducted a Joint Webinar with CEFLI Affiliate Member organization Guidehouse (formerly Navigant) on the subject of *Compliance's Role in Adapting to the New Business as Usual - Balancing Oversight with Agility*.

A recording of the webinar is available via CEFLI's website (www.cefli.org) under Events/Webinars/Past Webinars.

CEFLI staff will provide a brief report concerning the highlights of the recent Joint Webinar with CEFLI Affiliate Member organization, Guidehouse.

B. CEFLI COVID-19 Networking Forum – Thursday, June 18 and Thursday, July 2 – 3 PM EDT/2 PM CDT/1 PM MDT/12 Noon PDT.

The next meetings of CEFLI's new Networking Forum to explore COVID-19 operational issues will take place on Thursday, June 18 and Thursday, July 2 at 3 PM EDT/2 PM CDT/1 PM MDT/12 Noon PDT. Please contact Nancy Perez (NancyPerez@cefli.org) if you or your colleagues would like to be added to the new COVID-19 Networking Forum.

C. Joint Webinar - *SEC Regulation Best Interest - What's Next For Life Insurance Companies?* CEFLI/Deloitte - Thursday, July 16 - 1 PM EDT/12 Noon CDT/11 AM MDT/10 AM PDT.

CEFLI plans to conduct a Joint Webinar with Affiliate Member organization, Deloitte, to discuss *SEC Regulation Best Interest - What's Next For Life Insurance Companies?* following the June 30, 2020 compliance date.

Please mark your calendars and plan to join us on Thursday, July 16 at 1 PM EDT/12 Noon CDT/11 AM MDT/10 AM PDT.

VI. Next Meeting.

Please note that there have been date changes for the next two Compliance & Ethics Committee meetings as noted (in highlighting) below.

The next meeting of the Committee is scheduled to take place:

Wednesday, July 15 ~~22~~, 2020 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT

Please mark your calendar and plan to join us!

The remaining Committee meeting dates for 2020 will be as follows:

Wednesday, August 12 ~~19~~, 2020 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
Wednesday, September 16, 2020 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
Wednesday, October 14, 2020 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
Wednesday, November 12, 2020 - 2 PM EST/1 PM CST/12 Noon MST/11 AM PST
Wednesday, December 16, 2020 - 2 PM EST/1 PM CST/12 Noon MST/11 AM PST

VII. Other Business.

The Committee will be asked to identify and discuss any other business to be brought before the Committee.

COMPLIANCE & ETHICS FORUM FOR LIFE INSURERS

DRAFT

Minutes
Meeting of the
CEFLI Compliance & Ethics Committee
May 13, 2020

A meeting of the CEFLI Compliance & Ethics Committee (the "Committee") was held via conference call on Wednesday, May 13 at 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT.

The following CEFLI member company representatives participated in the meeting:

Ro Adebiyi, Thrivent
Molly Akin, Ohio National
Dwain Akins, American National
Derek Albanese, UNUM
Marcie Allen, Texas Life
Jenna Austin, Guggenheim Life and Annuity Company
Brendan Bakala, Catholic Order of Foresters
Lauren Barbaruolo, Oxford Life Insurance
Ann Binzer, Cincinnati Life
Kate Blalock, Western & Southern
Matteo Boettger, Lombard International
Emmanuelle Brooks, Pacific Life
Jason Broussard, American National
Donna Brown, Lombard International
Vickie Bulger, Primerica
Amy Burggraff, Securian Financial
Sheila Burton, Athene
Matthew Chisholm, Erie Insurance
Harvey Chu, Symetra Life
Deb Cooper, Securian Financial
Steve Corbly, The Cincinnati Life
Jacquie Crader, CUNA Mutual
Nicholas Criscitelli, Voya Financial
Rebecca Criswell, Americo
Kathy Deputy, State Farm
Latrina Edwards, AAA Life
Jill Fiddler, Assurity Life
Kris Fischer, Thrivent
Toba Fryer, John Hancock
Patrick Garcy, Sagicor Life

Tracy Gardner, RiverSource
Paula Gentry, The Cincinnati Life
Jennifer Gibb, Pacific Life
Jim Golembiewski, Sagicor Life
Rachel Gomez, State Farm
Meagan Gonzales, Oxford Life
Steve Harris, Lincoln Financial
Craig Hopkins, Pacific Life
Donna Hough-Zukas, Sunlife
Belinda Howard, Principal Life
Nathan Huss, Sammons
Martin Karp, Oxford Life
Jennifer Knabe, Ohio National
Megan Knapp, American Enterprise
Steve Koslow, Allianz Life
Hannah Krone, Western & Southern
Marla Lacey, Homesteaders Life
Brian Leary, Fidelity Investments
Dan LeBlanc, SBLI
Khrystie Lee, RiverSource
Laurie Lewis, Amica Life
Allison Martinson, Western & Southern
Kevin Mechtley, Sammons
Dave Milligan, American Equity
Morgan Milner, Modern Woodmen
Matt Missik, Pacific Life
Valerie Murray, Lombard International
Ryan Meehan, Ameriprise Financial
Monique Pascual, Pacific Guardian Life
Liza Perry, USAA Life
Megan Phillips, Principal Life
Tony Poole, AAA Life
Tamieka Porter, AAA Life
Sandy Ray, Symetra Life
Sally Roudebush, Lincoln Heritage
Keith Schroeder, American Amicable
Ryan Schwoebel, Protective Live
John Sharp, Assurity Life
Leslie Smith, Southern Farm Bureau Life
Alison Soderberg, Lombard International
Lori Straight, Sammons
Stephanie Teater, Western & Southern
Kristen Thomas, Jackson Life
Bill Turner, American Fidelity
Jane Uselis, Catholic Order of Foresters

Laura VanLaningham, Illinois Mutual
Bart Vitou, Jackson Life
Rochelle Walk, WiltonRe
Lais Washington, SunLife
Jaime Waters, EquiTrust Life
Larry Welch, Citizens
Tracy Whitaker, Homesteaders Life
Emily Wilburn, Illinois Mutual
Christopher Wilkie, Baltimore Life

Donald J. Walters, President & CEO, Carla Strauch, Vice President - Compliance & Ethics, and Mallory Bennett, Director of Member Relations, Communications and Meetings, also attended the meeting.

I. Welcome and Introduction.

The meeting began with a recitation of CEFLI's anti-trust statement.

II. Approval of Minutes – April 15, 2020.

On motion, duly made and seconded and unanimously carried, the Committee: RESOLVED, that, the Minutes of the April 15, 2020 meeting are hereby approved.

III. Issues for Review.

A. Coronavirus (COVID 19).

CEFLI's COVID-19 Networking Forum continues to meet every two weeks to explore various compliance-related issues associated with the COVID-19 pandemic. Our thanks to Chad Eslinger of VOYA Financial and Jason Broussard of American National for their willingness to serve as moderators for our most recent Networking Forum discussions.

Committee members were reminded that the next meeting of the COVID-19 Networking Forum is scheduled to take place on Thursday, May 21 at 3 PM EDT. Members may contact Nancy Perez (NancyPerez@cefli.org) to be added to the COVID-19 Networking Forum.

Committee members were asked to discuss current compliance challenges associated with issues arising out of the COVID-19 pandemic and, specifically, whether their companies have imposed a ban on non-essential travel and whether their companies have announced plans regarding "return to work" strategies over the weeks and months ahead.

Several Committee members noted travel bans. One member noted a travel ban

until further notice, with any exceptions requiring approval from the CEO. Another Committee member noted a travel ban until at least Labor Day. Another member indicated the company's President must approve all travel and that employees are asked to self-quarantine for 14 days following any personal travel.

Committee members also shared insight regarding their "return to work" plans. One Committee member noted current efforts to develop a plan. Another member noted it will have staff return to work in stages. One member indicated it would begin slowly sending staff back to the office on a voluntary basis beginning next week. The member further indicated the company had enhanced its onsite safety and sanitation efforts and that it had established distancing requirements. Another Committee member indicated its employees would be sent back in four (4) weekly tranches, each comprising 25% of the workforce; meaning, only a quarter of the workforce would be in the office at the same time.

B. *AMICA v. Wertz*.

Since the Committee's last meeting, a decision was rendered by the Colorado Supreme Court in the case of *AMICA v. Wertz*.

In *AMICA v. Wertz*, a question was presented concerning a conflict between a Colorado statute and the standards of the Interstate Insurance Product Regulatory Commission (IIPRC) (the "COMPACT") related to a suicide exclusion clause within the applicable policy. While the COMPACT utilizes a two-year exclusion standard, Colorado law limits the exclusion to one year. The Colorado Supreme Court ruled in favor of the one-year Colorado suicide exclusion law. Subsequently, the COMPACT held a conference call to discuss the decision and suggested that the decision should be interpreted narrowly to only cover situations in which there was a state statute that included a provision that was more favorable to the consumer than the provision in COMPACT standards.

Committee members were asked to discuss their reaction to the *AMICA v. Wertz* decision and whether it may have an impact on insurers' willingness to submit policy application forms for approval by the COMPACT.

The Committee was also reminded of the *New York Life vs. Ortiz* case in which a Rhode Island court had ruled that interest should be paid consistent with the Compact's 3% interest rate, not the state's 9% interest rate.

One Committee member indicated that Illinois market conduct examiners had taken the position that the calculation of interest payable on death claims and the payment period for such claims should align with Illinois's standards even though such standards are less favorable to consumers than Compact standards.

It was noted that the General Counsel for the Rhode Island Insurance Department is developing a list of state statutes that conflict with Compact standards regarding interest payments. It was noted that two states (Missouri and Colorado) were identified and that there are 4-5 states with different reinstatement provisions compared to the COMPACT's 3-year standard. State requirements regarding free look provisions also vary from Compact standards.

C. Payment of Interest on Death Benefits – CEFLI Quick Poll.

CEFLI recently conducted a Quick Poll on the calculation of the payment of interest on death benefits for life insurance policies. Of the 16 respondents, 75% (12 companies) pay the higher of the state interest rate or the rate indicated in the insurer's contract when processing death claims payments while 25% of respondents (4 companies) pay interest at a rate consistent with the state's interest rate at date of death. No companies responding to the Quick Poll indicated that interest was paid at a rate consistent with the rate specified in the insurance contract.

Committee members were asked to share their perspectives on the results of the Quick Poll (i.e., to confirm whether the Quick Poll's results are consistent with general industry practice) and to discuss whether they have experienced recent market conduct examination activity in this area and, if so, whether any state insurance departments have provided recent guidance on this issue. No Committee members offered insight in this area.

D. Policies and Procedures Regarding How "Agents/Producers" May Characterize Themselves.

In late April, the SEC issued additional guidance to its list of frequently asked questions concerning the implementation of Regulation Best Interest. The updates included guidance for firms regarding whether individuals that may be affiliated with a broker-dealer but not also registered as an investment adviser may use the terms "adviser" or "advisor" to describe their role. The SEC opined that use of the terms "adviser" or "advisor" in a name or title broker-dealer who is not also registered as an investment advisor is a violation of the requirement to disclose the broker-dealer's capacity under Regulation Best Interest's Disclosure Obligation. The SEC further clarified that a broker-dealer that is also a state-registered investment adviser may use the title "adviser" or a "advisor" in describing the broker-dealer.

The Committee was asked to discuss the extent to which life insurance companies have policies and procedures in place to limit the use of terms or various titles such as "agent" or "producer" (or other acceptable titles) for individuals selling life insurance company products.

Generally, Committee members noted that agent and producer titles, including those referencing Advisor or Adviser are based on the producer's specific credentials. From an oversight perspective, Committee members noted that their advertising and social media reviews often identified any situations in need of further exploration. One member indicated it requires its insurance-only producers to disclose the limitations in the services they can offer as an insurance-only producer. A few Committee members indicted they moved away from the use of the word Advisor or Adviser in producer titles, in favor of more generic titles such as Financial Professional or Financial Representative.

E. Suspicious Activity Reports (SARs):

Life insurance companies must comply with a variety of federal regulations including, as applicable, the submission of Suspicious Activity Reports (SARs) related to suspected fraudulent activities. A series of questions was posed, related to the filing of SARs:

- *What is the frequency of reporting to your company's Board of Directors, Audit Committee or other appropriate Board Committees pertaining to the filing of SARs?*
- *For internal SARs reporting, are supporting written materials provided in addition to a verbal report?*

The Committee was asked to discuss their practices with respect to reporting the filing of SARs information to the company's Board of Directors, Audit Committee or other appropriate Board Committees.

A few Committee members shared company practices in this area, indicating that SARs reporting was generally conducted annually and in written form, with some verbal updates, to the company's Board, or to a Board Committee, and to appropriate senior management.

F. Design of Antifraud Programs.

A series of questions was presented with respect to the design and governance of life insurance company antifraud programs. The questions included:

- *Does your company have a formal corporate antifraud governance structure? If yes, does your antifraud program cover the entire enterprise or only specific entities or lines of business?*

- *Does your company have an individual designated as an Antifraud Officer and/or a Management Committee responsible for managing antifraud risk?*

- *Do you have one or more compliance staff with the Certified Fraud Examiner (CFE) designation?*

- *What is the average length (number of pages) of corporate antifraud plans required to be filed with the states?*

The Committee was asked to discuss their knowledge of the design and governance of their company's antifraud programs.

One member noted its SIU function is part of the company's Claims Department and that antifraud reports vary in length based on differing state laws specifying the content to be included in such reports. Another Committee member noted its use of a quarterly fraud review team for the purpose of identifying potential policy and procedure changes, future training needs, etc. The member indicated that at least one senior fraud examiner on the company's team has an advanced designation.

One Committee member shared insight regarding the company's efforts to integrate internal fraud (e.g., employee fraud) into the company's existing antifraud policy.

G. Idaho House Bill 526.

The State of Idaho recently enacted a new law which requires prior approval from the Idaho Director of any advertisement of interest-indexed annuity contracts, regardless of the advertising medium, before its use. Several questions were presented concerning how insurers plan to comply with the requirement, including:

- *Will companies be submitting solely customer-facing advertisements for prior approval?*
- *Will companies submit only advertisements related to a specific product for prior approval?*
- *Will companies submit advertisements for products approved by Idaho on an individual basis as opposed to products approved through the COMPACT?*

The Committee was asked to discuss their company's strategies to comply with the prior approval requirement for indexed annuity advertisements in the State of Idaho. Committee members did not offer comments in this area.

H. Oversight and Supervision of "Wholesalers."

Life insurance companies may utilize "wholesalers" to promote the sale of their products with various distribution systems. When "wholesalers" promote the sale

of a company's products, unique compliance issues may arise with respect to the oversight and supervision of "wholesalers."

The Committee was asked to discuss the extent to which their company may rely upon "wholesalers" to promote the sale of their company's products and, if so, to describe the types of oversight and supervision practices related to "wholesalers'" activities.

One Committee member indicated its oversight program results in 25% of wholesalers being reviewed each year as part of a four (4) year rotation schedule. The member also indicated it maintains a compliance manual for wholesalers and that it provides related training. Further, internal wholesalers are subject to call reviews, Compliance attends wholesaler meetings, annual interviews are conducted, and the company requires an annual certification or assertion from each wholesaler.

Another Committee member indicated they conduct virtual office inspections every year for their external wholesalers and that their internal sales calls are supervised and subject to regular oversight by the Compliance Department.

I. Iowa Adopts – Best Interest Rule – Based on Revised NAIC Suitability in Annuity Transactions Model Regulation.

The State of Iowa, who took a leadership role in developing the recent revisions to the NAIC Suitability in Annuity Transactions Model Regulation, has adopted its own "Best Interest Rule" which is based upon the revised version of the Model Regulation. The new Iowa Rule becomes effective January 1, 2021.

The Committee was asked to discuss their knowledge with respect to other states' plans to introduce any other versions of the revised NAIC Suitability in Annuity Transactions Model Regulation for adoption in selected states.

One Committee member referenced Arizona's past legislative efforts to enact a state-specific law containing provisions similar to the revised version of the Model Regulation. Enactment of this legislative proposal was hampered as a result of the pandemic.

IV. Reporting Items. CEFLI Staff.

A. Regulation Best Interest Lawsuit to Be Heard in Early June.

A lawsuit filed by seven states as well as a network of investment advisers regarding the SEC's Regulation Best Interest will be heard by the US Court of Appeals for the Second Circuit during the week of June 1 with a decision likely to

be rendered prior to the end of June in order to precede the June 30 effective date for Regulation Best Interest.

Industry observers suggest that the SEC will be likely to prevail in this lawsuit. Nevertheless, companies should continue to plan their compliance strategies with the June 30 effective date for Regulation Best Interest in mind.

A. DOL Fiduciary Rule Still Anticipated.

The DOL recently announced that Preston Rutledge, the DOL Assistant Secretary and head of the Employee Benefits Security Administration, is going to leave his position at the end of May. Mr. Rutledge was leading the effort to rewrite the DOL Fiduciary Rule which was vacated by the Fifth Circuit Court of Appeals in 2018.

Recent news reports from the DOL suggest that work on a revised Fiduciary Rule continues and that the new rule is anticipated by the end of the year. It is likely that the new rule will be designed to complement the key provisions of the SEC's Regulation Best Interest.

B. CARES Act Waives 2020 Required Minimum Distributions.

The Coronavirus Aid, Relief and Economic Security Act (the "CARES Act") included a waiver of the requirement to take Required Minimum Distributions (RMDs) from IRAs, 401(k) and 413B plans. A similar waiver was granted during the 2009 financial crisis.

Earlier this year, we had discussed the fact that the SECURE Act signed into law at the end of 2019 also impacted RMD requirements. We also discussed whether companies would be sending notices regarding the change in RMD requirements.

Now, given the waiver from having to take RMDs in 2020, retirement plan participants will no longer be required to take RMDs in 2020.

C. FINRA Warns of Phishing Scam.

FINRA recently issued Regulatory Notice 20-12 which warns firms of a possible fraudulent phishing email scheme. The emails request immediate attention to an attachment related to your firm which purports to be sent from senior FINRA officials.

The emails, which are sent from an email address with the domain "broker-FINRA.org" is not connected to FINRA and firm should delete all emails originating from this domain name.

D. COVID-19 Pandemic Delays New Jersey's Final Fiduciary Rule.

The New Jersey Securities Bureau introduced a proposed fiduciary rule last year. Under New Jersey law, rule proposals expire after one year if a final rule is not promulgated.

New Jersey Governor Phil Murphy recently issued an Executive Order extending the deadline for proposed rules issued on or after April 15, 2020 until 90 days after the state's health emergency is lifted.

Though the New Jersey Securities Bureau has not released a final fiduciary rule, the delay of a possible New Jersey fiduciary rule adds additional uncertainty as to whether a fiduciary rule may be forthcoming after the COVID-19 pandemic health emergency may be lifted in the state of New Jersey.

E. Personnel Issues - New Maryland Insurance Commissioner – Kathleen Birrane.

It was recently announced that the Maryland Insurance Administration will have a new Commissioner.

Al Redmer, Jr., who served as the Maryland Insurance Commissioner most recently from January 2015, has announced he will step down in order to lead the Maryland Auto Insurance Fund; a state-sponsored entity that provides automobile insurance to Maryland residents.

Maryland Governor Larry Hogan has appointed attorney Kathleen Birrane as the new Maryland Insurance Commissioner. Ms. Birrane was the former principal counsel to the Maryland Insurance Administration and will require Maryland Senate confirmation to assume her new duties.

V. CEFLI Activities.

A. CEFLI Virtual Summit Meeting - Now Available Online.

Earlier this year, CEFLI planned to conduct an Educational Summit Meeting in Des Moines, Iowa, to review the recent revisions to the NAIC Suitability in Annuity Transactions Model Regulation and their potential implications for current compliance practices related to annuity distribution.

In light of the COVID-19 pandemic, CEFLI opted to provide the information that would have been shared at the Educational Summit Meeting by conducting a "Virtual Summit Meeting" containing the same sessions, faculty members and information that would have been provided at the in-person Educational Summit Meeting.

Last month, CEFLI launched its Virtual Summit Meeting which includes five different segments to provide insights offered by company representatives, regulators and industry experts regarding the key compliance provisions of the new version of the NAIC Suitability in Annuity Transactions Model Regulation.

Key topics include:

- An Overview of the ***Emerging and Dynamic Sales Standards*** that led to the revisions to the NAIC Suitability in Annuity Transactions Model Regulation;
- A review of the ***Disclosures*** required by the Model Regulation;
- Insurer ***Training*** requirements posed by the Model Regulation;
- Insurer ***New Business Processes*** in light of the Model Regulation; and
- ***Oversight and Supervision*** practices required by the Model Regulation.

The Virtual Summit Meeting sessions are now available "on demand" on this page of CEFLI's website (www.CEFLI.org) along with several summary and reference documents developed by CEFLI.

B. Joint Webinar - *Digital Transformation: How Insurers Land on Top As a Result of COVID-19* - CEFLI/Guidehouse (formerly Navigant) - Wednesday, June 10 - 1 PM EDT/12 Noon CDT/11 AM MDT/10 AM PDT.

CEFLI is pleased to announce it will be conducting a Joint Webinar with CEFLI Affiliate Member organization Guidehouse (formerly Navigant) on the subject of *Digital Transformation: How Insurers Land on Top as a Result of COVID-19*.

The COVID-19 pandemic presents numerous compliance-related issues including taking applications remotely, pursuing effective compliance strategies in a work-from-home environment and managing underwriting needs at a time when insurance fraud may be more prevalent than ever.

Please mark your calendars and plan to join us on Wednesday, June 10 at 1 PM EDT/12 Noon CDT/11 AM MDT/10 AM PDT for this important discussion.

C. CEFLI COVID-19 Networking Forum – Thursday, May 21 and Thursday, June 4 – 3 PM EDT/2 PM CDT/1 PM MDT/12 Noon PDT.

The next meetings of CEFLI's new Networking Forum to explore COVID-19 operational issues will take place on Thursday, May 21 and Thursday, June 4 at 3 PM EDT/2 PM CDT/1 PM MDT/12 Noon PDT. Please contact Nancy Perez (NancyPerez@cefli.org) if you or your colleagues would like to be added to the new COVID-19 Networking Forum.

VI. Next Meeting.

The next meeting of the Committee is scheduled to take place:

Wednesday, June 17, 2020 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT

Please mark your calendar and plan to join us!

The remaining Committee meeting dates for 2020 will be as follows:

Wednesday, July 22, 2020 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
Wednesday, August 19, 2020 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
Wednesday, September 16, 2020 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
Wednesday, October 14, 2020 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
Wednesday, November 11, 2020 - 2 PM EST/1 PM CST/12 Noon MST/11 AM PST
Wednesday, December 16, 2020 - 2 PM EST/1 PM CST/12 Noon MST/11 AM PST

VII. Other Business.

There being no additional business the meeting was adjourned.

1 AN ACT

2 relating to certain disclosures and notices required for certain
3 life insurance policies.

4 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF TEXAS:

5 SECTION 1. Chapter 1101, Insurance Code, is amended by
6 adding Subchapter E to read as follows:

7 SUBCHAPTER E. DISCLOSURES AND NOTICES RELATING TO LIFE INSURANCE
8 POLICIES WITH NON-GUARANTEED CHARGES

9 Sec. 1101.201. PURPOSE. This subchapter is intended to
10 provide standards for disclosures relating to changes in certain
11 non-guaranteed charges of life insurance policies subject to this
12 subchapter.

13 Sec. 1101.202. DEFINITIONS. In this subchapter:

14 (1) "Adverse change" means a change by an insurer in
15 the insurer's current scale of charges applied to a policy that
16 increases a premium or charge to a policy owner.

17 (2) "Current scale of charges" means the scale or
18 schedule of non-guaranteed charges in effect for a policy during
19 the period of time immediately before an adverse change to the
20 policy.

21 (3) "Non-guaranteed charges" means the scale or
22 schedule of charges in a policy provision at the time the policy was
23 issued that may be changed at the insurer's discretion without the
24 consent or request of the policy owner. The term does not include a

1 policy loan interest rate charged on a policy loan.
2 Sec. 1101.203. APPLICABILITY. (a) This subchapter applies
3 to a life insurance policy issued by an insurer, as defined by
4 Section 1102.001, that contains non-guaranteed charges that may
5 change at the discretion of the insurer.
6 (b) This subchapter does not apply to:
7 (1) group life insurance without separately
8 identifiable accounts for insureds;
9 (2) a life insurance policy in which the insurer
10 assumes all risk and contractually guarantees a death benefit in
11 exchange for a guaranteed premium set at the time of the policy's
12 issuance;
13 (3) an individual or group annuity contract;
14 (4) credit life insurance;
15 (5) a life insurance policy with no illustrated death
16 benefits on any individual exceeding $10,000;
17 (6) a bank-owned or corporate-owned life insurance
18 policy; or
19 (7) a life insurance policy that does not provide for
20 cash values or nonforfeiture values.
21 Sec. 1101.204. DISCLOSURE OF NON-GUARANTEED CHARGE
22 INCREASE AFTER ISSUANCE OF POLICY. (a) If an insurer increases a
23 non-guaranteed charge applied to a policy, the insurer must provide
24 a written notice to the policy owner:
25 (1) disclosing:
26 (A) each non-guaranteed charge that has changed;
27 (B) the new scale of non-guaranteed charges after

1 the change;
2 (C) the current scale of charges; and
3 (D) the guaranteed maximum scale of charges; and
4 (2) including a prominent display of any adverse
5 change in the current scale of charges identifying:
6 (A) the nature of the change;
7 (B) that the change is adverse or the conditions
8 under which the change would be adverse; and
9 (C) the new age and year at which the policy will
10 lapse if there are no changes to payments or coverage.
11 (b) The notice under Subsection (a) must include the
12 insurer's telephone number and the following statement placed
13 prominently on the front of the notice:
14 "YOU SHOULD KNOW: This increase may change the value of your
15 policy and may change how long your policy will last unless you
16 increase your premium payments or reduce your coverage, if
17 permitted under your policy. Ask your insurance company for an
18 illustration, at no cost, that shows the effect of this change on
19 your policy and discuss with your agent or financial advisor other
20 options that are available to you."
21 (c) The notice required by Subsection (a) must be given not
22 later than the 90th day before the date the change is applied.
23 (d) The notice required by Subsection (a) does not
24 constitute an illustration, as defined by rules adopted by the
25 department relating to life insurance illustrations.
26 Sec. 1101.205. DISCLOSURE OF CREDITED INTEREST RATE
27 DECREASE AFTER ISSUANCE OF POLICY. (a) If an insurer decreases the

1 credited interest rate paid on a policy's accumulation value, the
2 insurer must provide annually a written notice to the policy owner:
3 (1) disclosing:
4 (A) the new current credited interest rate;
5 (B) the previous credited interest rate;
6 (C) the minimum credited interest rate stated in
7 the policy; and
8 (D) the effective date of the change; and
9 (2) including a prominent display of the new age and
10 year at which the policy will lapse based on all changes to
11 non-guaranteed charges and the credited interest rate if there are
12 no changes to payments or coverage.
13 (b) The notice under Subsection (a) must include the
14 insurer's telephone number and the following statement placed
15 prominently on the front of the notice:
16 "YOU SHOULD KNOW: This decrease may change the value of your
17 policy and may change how long your policy will last unless you
18 increase your premium payments or reduce your coverage. Ask your
19 insurance company for an in-force illustration that shows the
20 effect of this change on your policy and discuss with your agent or
21 financial advisor other options that are available to you."
22 (c) Notwithstanding any other provision of this section,
23 this section does not apply to or require disclosures for a variable
24 universal or indexed life insurance policy.
25 Sec. 1101.206. ANNUAL ILLUSTRATION. Regardless of whether
26 any non-guaranteed charges are changed, an insurer that issues a
27 policy subject to this subchapter must offer to provide to the

1 policy owner at least annually an in-force illustration. If the
2 insurer has changed any non-guaranteed charges or the credited
3 interest rate, the insurer must offer the illustration at no
4 charge.
5 Sec. 1101.207. RULES. (a) The commissioner may adopt rules
6 as necessary to implement this subchapter.
7 (b) The commissioner by rule may exempt certain types of
8 life insurance policies from one or more of the requirements of this
9 subchapter.
10 (c) Section 2001.0045, Government Code, does not apply to
11 rules adopted under this section.
12 SECTION 2. Subchapter E, Chapter 1101, Insurance Code, as
13 added by this Act, applies only to an increase in a non-guaranteed
14 charge applied to an insurance policy on or after January 1, 2020.
15 Subchapter E, Chapter 1101, Insurance Code, as added by this Act,
16 applies only to a decrease in a credited interest rate applied to an
17 insurance policy on or after January 1, 2021.
18 SECTION 3. This Act takes effect September 1, 2019.

______________________________ ______________________________

President of the Senate Speaker of the House

I certify that H.B. No. 207 was passed by the House on April 18, 2019, by the following vote: Yeas 146, Nays 1, 2 present, not voting; and that the House concurred in Senate amendments to H.B. No. 207 on May 23, 2019, by the following vote: Yeas 140, Nays 0, 1 present, not voting.

____

Chief Clerk of the House

I certify that H.B. No. 207 was passed by the Senate, with amendments, on May 21, 2019, by the following vote: Yeas 31, Nays 0.

____

Secretary of the Senate

APPROVED: _____________________

Date

____

Governor

FIRST DISTRICT COURT OF APPEAL
STATE OF FLORIDA

No. 1D18-2114

JIMMY PATRONIS, in his official capacity as Chief Financial Officer of the State of Florida, and the FLORIDA DEPARTMENT OF FINANCIAL SERVICES,

Appellants,

v.

UNITED INSURANCE COMPANY OF AMERICA; THE RELIABLE LIFE INSURANCE COMPANY; MUTUAL SAVINGS LIFE INSURANCE COMPANY; and RESERVE NATIONAL INSURANCE COMPANY,

Appellees.

On appeal from the Circuit Court for Leon County.
Terry Lewis, Judge.

June 3, 2020

MAKAR, J.

This case involves life insurance, unclaimed property, and the ominous sounding "Death Master File," which is a federal electronic database administered by the Social Security Administration that includes the agency's records of the names, social security numbers, dates of birth and, of course, dates of

death for individuals, going back many decades. Over the past two decades, the insurance industry's selective use of the DMF spawned numerous investigations and reports, litigation by state attorneys general, insurer settlements over disputed practices, and ultimately nationwide reforms. The controversy arose because insurers were routinely using the DMF to identify and stop paying annuities to deceased annuity holders, but they were not using it to identify deceased insurance policyholders, resulting in an asymmetric practice that benefited insurers and disadvantaged consumers of life insurance. Failing to promptly identify a policyholder's death has many detrimental effects: beneficiaries are not notified or paid benefits, premiums continue to be deducted from the deceased's accounts, and the five-year "dormancy" period before unclaimed death benefits are transferred to the State of Florida's custody isn't triggered (i.e., insurers continued to hold and invest hundreds of millions of funds for a longer period of time). *See* § 717.107(1), Fla. Stat. (2020) ("Funds held or owing under any life or endowment insurance policy or annuity contract which has matured or terminated are presumed unclaimed if unclaimed for more than 5 years after the date of death of the insured, the annuitant, or the retained asset account holder . . . .").

In response to industry practices and their adverse effects on consumers, the Florida Department of Financial Services (Department) issued a declaratory statement October 2013 that concluded that under existing law a life insurance policy "becomes a claim upon the death of the insured" and that insurers have a duty to search accessible databases to determine whether policyholders had died. That determination was ultimately invalidated in substantial part in *Thrivent Financial for Lutherans v. State, Department of Financial Services*, 145 So. 3d 178, 182 (Fla. 1st DCA 2014), which held that the Department's declaratory statement as to when proceeds are due and payable was erroneous. Under the then-existing version of section 717.107(1), Florida Statutes, this Court concluded that life insurance proceeds became "due and payable *as established from the records of the insurance company*" only when the insurer receives proof of death and the surrender of the policy in their official records. *Id.* at 180 (emphasis added). In other words, an insurer—though having statutory duty to act with due diligence—could passively await the arrival of

documents placed in its records before taking any action, sometimes decades after a policyholder's death.

In response to *Thrivent* and the ongoing industry practices, the Florida Legislature in 2016 removed the language that allowed insurers to passively rely on their company records and, instead, imposed a statutory duty on insurers to use the DMF (or its equivalent) at least annually (or as often as they use the DMF to check on annuity contracts) to compare DMF death records against holders of their life insurance policies and annuities. Ch. 2016-219, § 1, Laws of Fla. (codified at § 717.107(8), Fla. Stat. (2016)). The requirement to use the DMF applied to all "life or endowment insurance policies, annuity contracts that provide a death benefit, and retained asset accounts that were in force at any time on or after January 1, 1992" and the DMF was required to be used for all "future comparisons." *Id.* Upon discovering an insured is listed in the DMF, an insurer has 120 days to undertake various tasks to confirm the insured's death, to determine whether benefits may be due, and to make efforts to locate beneficiaries. *Id.* at § 1 (codified at § 717.107(9)). Finally, the 2016 act also changed the date upon which the five-year dormancy period was triggered to the date of an insured's death rather than the date the insurer received in its records proof of death of the insured (or the date the insured, if living, would reach the so-called mortality limiting age, i.e., an age in the applicable mortality table at which an insured is presumed dead). *Id.* at § 1 (codified at § 717.107(1)).

These three related amendments to the unclaimed property statute have been dubbed the "search amendment," the "contact amendment," and the "escheat amendment." The Legislature directed that the "amendments made by this act are remedial in nature and apply retroactively" and that any applicable fines, penalties, or additional interest would not be imposed for failures to report or remit an "unclaimed life or an endowment insurance policy, a retained asset account, or an annuity contract with a death benefit" if such assets are "reported and remitted to the Department of Financial Services on or before May 1, 2021." *Id.* at § 2. The effect of the 2016 amendments was to override this Court's decision in *Thrivent* by requiring a process that insurers must follow to make insurance proceeds more readily available to beneficiaries upon the death of an insured and to change and

generally shorten the timeframe for the escheat of unclaimed insurance proceeds.

In May 2016, four insurance companies challenged these amended portions of the 2016 act, seeking a declaration that retroactive application violates their state constitutional rights. No claim was made that the three amendments, applied prospectively, are invalid. The insurers' initial complaint alleged two counts, one claiming a denial of due process under article I, section 9, of the state constitution, and another claiming that the 2016 act was an unconstitutional impairment of contract under article I, section 10, of the state constitution. The latter count was subsequently voluntarily dismissed and eliminated in their last-amended complaint, leaving only the due process claim for adjudication, one the insurers stressed repeatedly throughout the litigation was only a *facial* challenge to the new statutory provisions ("The Second Amended Complaint as amended by dismissal of Count II asserts a single facial Due Process claim.") that required no discovery ("Because Plaintiffs' claim is a facial challenge to the Act involving no issues that require factual development, no discovery is necessary to resolve the fundamental legal questions presented.").

The insurers moved for summary judgment on their facial due process claim. Based solely on the parties' legal memoranda, the trial judge ruled in the insurers' favor, concluding that the three challenged aspects of the act violated due process and could only be applied prospectively. It held that the DMF search amendment, beneficiary contact amendment, and escheat-five-years-from-time-of-death amendment are substantive (rather than procedural or remedial), and that retroactive application of them (a) adversely affected the insurers' vested rights and (b) imposed new obligations and duties in connection with past transactions or considerations (it found it unnecessary to rule on whether they insurers were subject to new penalties). This appeal ensued.

I.

The theory of the insurers' case is that the three challenged portions of the 2016 act are facially unconstitutional under the

state due process clause, meaning they have no possible lawful applications. *Fraternal Order of Police, Miami Lodge 20 v. City of Miami*, 243 So. 3d 894, 897 (Fla. 2018) ("To succeed on a facial challenge, the challenger must demonstrate that no set of circumstances exists in which the statute can be constitutionally valid."); *Cashatt v. State*, 873 So. 2d 430, 434 (Fla. 1st DCA 2004) (a facial challenge "must fail unless no set of circumstances exists in which the statute can be constitutionally applied"). Stated differently, if a challenged portion has any lawful application, the insurers' facial challenge fails as to that portion. Showing that a statute "might operate unconstitutionally in some hypothetical circumstance is insufficient to render it unconstitutional on its face," which explains why a "facial challenge to a statute is more difficult than an 'as applied' challenge" as a general matter. *Ogborn v. Zingale*, 988 So. 2d 56, 59 (Fla. 1st DCA 2008) (quoting *Cashatt*, 873 So. 2d at 434); *see also Abdool v. Bondi*, 141 So. 3d 529, 538 (Fla. 2014) (statute "will not be invalidated as facially unconstitutional simply because it could operate unconstitutionally under some hypothetical circumstances"). Moreover, courts do not overturn statutes casually. That's because "statutes come clothed with a presumption of constitutionality" and "must be construed whenever possible to effect a constitutional outcome." *Brinkmann v. Francois*, 184 So. 3d 504, 507–08 (Fla. 2016) (citations omitted). The presumption of constitutionality is overcome only upon a showing of invalidity "beyond reasonable doubt," meaning that the presumption "applies unless the legislative enactments are clearly erroneous, arbitrary, or wholly unwarranted." *State v. Hodges*, 506 So. 2d 437, 439 (Fla. 1st DCA 1987) (citing *State v. State Bd. of Educ. of Fla.*, 467 So.2d 294 (Fla. 1985). "All doubts as to validity must be resolved in favor of constitutionality, . . . and if a constitutional interpretation is available, the courts must adopt that construction." *Hodges*, 506 So. 2d at 439 (internal citation omitted).

With this backdrop of standards governing our appellate review in this facial constitutional challenge, we turn to the merits.

II.

At the core of this litigation is whether the challenged amendments are remedial/procedural and thereby operate

retroactively, or, alternatively, whether they are substantive ones that—despite the Legislature's intent that they apply retroactively—impair vested rights, create new obligations, or impose new penalties. Some substantive amendments are capable of retroactive application, but not if they violate due process principles.

As to all three amendments, the trial court noted the difficulty of applying the general legal principle that "remedial" and "procedural" laws are constitutionally applied retroactively, *State Farm Mut. Auto. Ins. Co. v. Laforet*, 658 So. 2d 55, 61 (Fla. 1995) ("a procedural or remedial statute is to operate retrospectively"), while "substantive" laws may not be applied retroactively if they abolish or curtail protected rights or impose unconstitutional obligations. *See Maronda Homes, Inc. of Fla. v. Lakeview Reserve Homeowners Ass'n, Inc.*, 127 So. 3d 1258, 1272 (Fla. 2013) ("[A] substantive law prescribes legal duties and rights and, once those rights and duties are vested, due process prevents the Legislature from retroactively abolishing or curtailing them."). The trial court said:

> Like many definitions, this one is easier announced then applied. It is not difficult to imagine an interpretation that would render many statutes remedial, substantive and procedural at the same time. Indeed, the [three] amendments under review can be said to have remedial, procedural, and substantive aspects. The act operates to further a remedy and to confirm rights of life insurance beneficiaries, and directs how it is to be done. But it also proscribes new legal duties and imposes new obligations upon life insurance companies.

The trial court, though recognizing the "act operates to further a remedy and to confirm rights of life insurance beneficiaries[,]" nonetheless concluded that the three amendments were substantive and could be applied only prospectively. Although the question is a debatable one, we conclude that the three amendments to the unclaimed property act are remedial and facially valid.

To begin, unclaimed property laws are inherently remedial in nature and generally understood as advancing a state's strong interest in protecting consumers of financial and insurance services. Their raison d'être is principally to safeguard the economic rights of consumers by providing means to reunite unclaimed property, such as life insurance proceeds, with its rightful and lawful owners. Nationwide, unclaimed property laws—many deriving from the uniform act[1] on the topic—exist to advance this purpose.

In this same regard, the long-standing legislative purpose underlying chapter 717, entitled "Disposition of Unclaimed Property," is clear:

> This chapter shall be applied and construed as to effectuate its general purpose of protecting the interest of missing owners of property, while providing that the benefit of all unclaimed and abandoned property shall go to all the people of the state, and to make uniform the law with respect to the subject of this chapter among states enacting it.

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[1] *Unclaimed Property Act, Revised*, Uniform Law Commission, https://www.uniformlaws.org/committees/community-home?CommunityKey=4b7c796a-f158-47bc-b5b1-f3f9a6e404fa (last visited April 29, 2020) (the act provides a system for transferring property held by an entity other than the rightful owner to the state when it is deemed abandoned by the rightful owner. This revised act updates provisions on numerous issues, including escheat of "gift cards and other stored-value cards, life insurance benefits, securities, dormancy periods, and use of contract auditors.") (the first uniform act on unclaimed property was enacted in 1954, was superseded in 1981, 1995 and 2016); *see Comptroller of Treasury v. PHH Corp.*, 717 A.2d 950, 952 (Md. Ct. Spec. App. 1998) ("The Uniform Act is remedial legislation 'designed to put an end to the unearned and fortuitous enrichment of the holders of abandoned property and to provide instead for the interests of the citizens . . . and ensure that any such escheat would be for public benefit rather than for private gain.'" (citing *Riggs Nat'l Bank of Washington, D.C. v. District of Columbia*, 581 A.2d 1229, 1233–34 (D.C.App. 1990))).

§ 717.139(1), Fla. Stat. (2020) (adopted in 1987). The 2016 act punctuated this legislative purpose in stating that "[i]t is the public policy of the state to protect the interests of owners of unclaimed property. It is declared to be in the best interests of owners of unclaimed property that such owners receive the full amount of any unclaimed property without any fee." Ch. 2016-219, § 10, Laws of Fla. (codified at § 717.139(1), Fla. Stat. (2016)). Insurers and the states merely hold unclaimed property for the benefit of policyholders and beneficiaries and do not have a proprietary property interest in its ownership. For that reason, unclaimed property laws are interpreted broadly in favor of protecting consumers' interests, not those of the insurer or the government. In these situations, the state is deemed the preferred custodian of escheatable funds (versus private companies), such that unclaimed property laws are distinctively and characteristically ones that further important regulatory interests as well as the remedial purposes of safeguarding consumer interests and remedying marketplace imperfections. *See, e.g.*, *Yee v. Am. Nat'l Ins. Co.*, 185 Cal. Rptr. 3d 363, 365 (Cal. Ct. App. 2015) (unclaimed property laws have a "dual objective," which "is to end the fortuitous enrichment of holders of unclaimed property and to return such property to its rightful owner or, if that is not possible, to the state (i.e., escheat) for public benefit rather than for private gain.").

The Legislature made clear that it deems the challenged 2016 amendments to section 717.107 as remedial with retroactive application: "The amendments made by this act are remedial in nature and apply retroactively." Ch. 2016-219, § 2, Laws of Fla. This legislative statement arose from the need to correct insurance industry practices the act addressed. As to insurance proceeds, it is clear that some, if not many, insurers nationwide and in Florida were not complying with their pre-existing obligations to ensure that life insurance contracts were handled with consumers' interests in mind. Rather than vigilantly using the DMF (or some other equivalent or substitute) to track possible deaths of holders of life insurance, many insurers used the DMF only as a means to curtail annuity payments when an annuity recipient died. The investigations, litigation, and settlements in the industry nationwide over the past decade about the practices at issue in this

case, which need not be recounted in detail, provide the foundation for remedial statutes enacted in many states, including in Florida, to formally rectify industry practices harmful to consumers. The foremost purpose of the legislation was to "further a remedy or confirm rights that already exist[ed]" that were not being honored by all insurers. *Maronda Homes*, 127 So. 3d at 1272; Ch. 16-219, § 2, Laws of Fla. The imposition of a requirement that insurers use the DMF (or an equivalent), when most, if not all, insurers were already doing so as to annuities, does not facially seem as anything other than a modest attempt to remedy an industry problem with a search process that most insurers already used. The same can be said of the contact amendment, which merely codified practices that do not facially seem as anything unusual if the goal is to notify possible beneficiaries.

Finally, the requirement that the five-year escheat period begin at the insured's death presents a slightly more nuanced legal question as to remediation. Although the dormancy period of five years has not changed, the overall period during which insurers hold funds and earn interest will likely decline. And the new and typically shorter effective holding period might pose difficulties in situations where it is determined that a policy holder died a decade earlier and the five-year dormancy period has elapsed; in those situations, the insurer holds funds that presumptively should have already escheated to the State. As to these situations however, the 2016 act created a safe harbor provision, stating that no fines, penalties, or additional interest would be imposed if insurers had previously failed to report or remit unclaimed insurance proceeds but reported and remitted them to the Department by May 1, 2021. Ch. 2016-219, § 2, Laws of Fla. In other words, so long as insurers do the one-time check of the DMF as to pre-existing policies and document their due diligence in attempting to contact beneficiaries, they will not be subject to fines, penalties, or additional interest if done by the designated statutory date. On balance, the escheat amendment tips heavily towards the remedial purpose of chapter 717, which is "protecting the interest of missing owners of property, while providing that the benefit of all unclaimed and abandoned property shall go to all the people of the state[.]" § 717.139(2), Fla. Stat. (2020).

Overall, the three amendments are consistent with the remedial purpose of Florida's unclaimed property laws, supporting the conclusion—as intended by the Legislature—that they apply retroactively. The trial court was correct in concluding that the "act operates to further a remedy and to confirm rights of life insurance beneficiaries [remedial purpose], and directs how it is to be done [procedural]," but erred by invalidating all potential retroactive applications. On their face, the three amendments are intended to be, and are in fact, remedial in nature such that their retroactive application is generally permissible.

III.

Despite their remedial nature, the trial court concluded that the three amendments violated due process because they are substantive and "proscribe[d] new legal duties and impose[d] new obligations upon life insurance companies." A "substantive" label, however, does not necessarily preclude retroactive application. If statutory amendments are deemed substantive, two factors come into play in deciding whether they apply retroactively: "(1) whether the statute itself expresses an intent that it apply retroactively; and, if so, (2) whether retroactive application is constitutional." *Old Port Cove Holdings, Inc. v. Old Port Cove Condo. Ass'n One, Inc.*, 986 So. 2d 1279, 1284 (Fla. 2008). The intent of the Legislature is that the three amendments apply retroactively; but if doing so violates the constitution, the inquiry is at an end and the amendments are properly enjoined as to such applications. Thus, "[e]ven when the Legislature does expressly state that a statute is to have retroactive application, this Court has refused to apply a statute retroactively if the statute impairs vested rights, creates new obligations, or imposes new penalties." *Laforet*, 658 So. 2d at 61. The parties agree that insurers have no vested rights in unclaimed property, so the question before the trial court—after its determination of the substantive nature of the amendments—was whether the amendments facially and unconstitutionally impose new obligations or new penalties.

As to new obligations, the three amendments generally are consistent with the pre-existing duties of insurers under chapter 717. Those duties included: paying beneficiaries when insureds die; settling policy claims upon proof of death and policy surrender;

reporting and remitting to the Department the unclaimed proceeds within the five-year dormancy period; and conducting reasonable searches and using prudent means of locating insureds and beneficiaries. These pre-existing duties included a "due diligence" requirement stating that insurers are to use

> reasonable and prudent methods under particular circumstances to locate apparent owners of inactive accounts using the taxpayer identification number or social security number, if known, which *may include*, but are not limited to, *using a nationwide database*, cross-indexing with other records of the holder, mailing to the last known address unless the last known address is known to be inaccurate, or engaging a licensed agency or company capable of conducting such search and providing updated addresses.

§ 717.101(9), Fla. Stat. (2020) (emphasis added) (added by Ch. 2001-16, Laws of Fla.). The overall tenor and terminology of the pre-existing obligations were designed to ensure that insurers used due diligence and good faith efforts to ascertain whether policyholders had died and to locate beneficiaries so that policy proceeds would be given to the rightful owners.

Given the broad existing statutory duties of insurers, it cannot be concluded that the three amendments are a facially unconstitutional imposition of new obligations as to all insurers in all situations. It is likely that most insurers were already using the DMF or some other search tools in ascertaining whether annuity holders had died. The same is true as to their efforts to contact potential beneficiaries, which were already required by statute. Neither the search nor contact amendments can be said to be facially unconstitutional as "new obligations" in every instance. Perhaps an insurer can show that the search and contact amendments, as applied to its pre-existing insurance policies, pose an unconstitutional hardship, but no individual "as applied" challenge is made here. We see no general impediment or burden on all insurers as to justify facially invalidating these provisions in toto.

The search and contact requirements also do not change the central purpose or terms of pre-existing insurance contracts. Insurers continue to have an obligation to pay only upon proof of death and surrender of the policy. *See* §§ 627.461 & 717.107, Fla. Stat. (2020). Those core obligations remain unchanged. Perhaps an insurer may have insurance contracts in its portfolio that have search and contact requirements that are so negatively impacted by the search and contact amendments as to be a due process violation; but, again, an as-applied challenge would be required to resolve such a matter. Although we determine that the amendments are remedial, even if they are deemed substantive their retroactive application is valid: the Legislature clearly expressed a remedial intent and the amendments are facially constitutional.

As to new penalties, the trial court—having ruled in the insurers' favor on other grounds—chose not to adjudicate the issue. The insurers ask that we affirm the trial court's ruling on this undecided ground under the Tipsy Coachman doctrine, i.e., that affirmance is warranted on alternative grounds if the record establishes a basis for doing so. *See Dade Cty. Sch. Bd. v. Radio Station WQBA*, 731 So. 2d 638, 644 (Fla. 1999) ("Stated another way, if a trial court reaches the right result, but for the wrong reasons, it will be upheld if there is any basis which would support the judgment in the record."). We hesitate to do so primarily because the insurers' facial challenge would require us to conclude that no possible application of the penalty provisions is constitutional, an undertaking fraught with difficulty on an undeveloped record. Though it is conceivable that some insurers may have valid claims, it is not clear that all would, making this issue one more amenable to as-applied challenges.[2]

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[2] We note that the act provides a safe harbor provision stating that no fines, penalties, or additional interest would be imposed if insurers had previously failed to report or remit unclaimed insurance proceeds but reported and remitted them to the Department by May 1, 2021. Ch. 2016-219, § 2, Laws of Fla. This provision ameliorates some, but not all, of the concerns raised.

Finally, we do not view *Thrivent* as precluding the Legislature from enacting remedial measures designed to address and rectify the types of insurance industry practices that potentially thwart the interests of policyholders, beneficiaries, and the State. *Thrivent* addressed the limited question, under the prior version of the statute, of when insurance proceeds become "due and payable" and did not speak to the extent to which the Legislature could enforce the "due diligence" requirements of section 717.101(9); rather, the Department in *Thrivent* "argue[d that] *this court* should impose an affirmative duty on insurers to search death records in order to ascertain whether any insured has died." 145 So. 3d at 182 (emphasis added). This Court rightly chose not to do so, but that does not prevent the Legislature from enacting a remedial statute that further defines, clarifies, or refines the pre-existing and long-standing obligation of insurers to use due diligence and act in good faith as to their insureds.

REVERSED.

M.K. THOMAS, J., concurs; WINOKUR, J., dissents with opinion.

APPENDIX

> (8)(a) Notwithstanding any other provision of law, an insurer shall compare the records of its insureds' life or endowment insurance policies, annuity contracts that provide a death benefit, and retained asset accounts that were in force at any time on or after January 1, 1992, against the United States Social Security Administration Death Master File once to determine whether the death of an insured, an annuitant, or a retained asset account holder is indicated and shall thereafter use the Death Master File update files for future comparisons. The comparisons must use the name and social security number or date of birth of the insured, the annuitant, or the retained asset account holder. The comparisons must be made on at least an annual basis before August 31 of each year. If an insurer performs such comparisons regarding its annuities or other books of business more frequently than once a year, the insurer must also make comparisons regarding its life insurance policies, annuity contracts that

> provide a death benefit, and retained asset accounts at the same frequency as is made regarding its annuities or other books or lines of business. An insurer may perform the comparisons required by this paragraph using any database or service that the department determines is at least as comprehensive as the United States Social Security Administration Death Master File for the purpose of indicating that a person has died.

Ch. 2016-219, § 1, Laws of Fla.

Not final until disposition of any timely and authorized motion under Fla. R. App. P. 9.330 or 9.331.

WINOKUR, J., dissenting.

Undeniably, a sound argument can be made that the disputed statutory requirements can be constitutionally applied to insurance policies that were executed prior to the effective date of chapter 2016-219, Laws of Florida (the Act). Nor is it deniable that the aims of the new law are salutary, as set out admirably in the majority opinion. But our supreme court has already decided clearly when new statutory requirements related to insurance policies can be imposed. Under this binding case law, we have no option but to conclude, as the trial judge did, that application of the new requirements to existing policies violates the constitutional rights of appellees. For this reason, I believe we must affirm the trial judge's order.

1. Facial vs. as-applied challenge

The majority claims that the insurers cannot make a case that the disputed law is facially unconstitutional, which requires them to prove that the challenged law has "no possible lawful applications." Maj. op. at 4-5. Instead, the majority suggests that the specificity of many of the insurer's claims show that they are best suited to as-applied challenges, which can be made when

certain actions are taken against them.[1] I find no such impediment.

As the United States Supreme Court has explained, "the distinction between facial and as-applied challenges is not so well defined that it has some automatic effect or that it must always control the pleadings and disposition in every case involving a constitutional challenge. The distinction . . . goes to the breadth of the remedy employed by the Court, not what must be pleaded in a complaint." *Citizens United v. Fed. Election Comm'n*, 558 U.S. 310, 331 (2010). In other words, it is the remedy sought that determines whether a challenge is facial or as-applied.

The insurers' complaint made clear what portion of the Act it alleged was unconstitutional. Section 2 of Chapter 2016-219, Laws of Florida, reads in part, "[t]he amendments made by this act are remedial in nature and apply retroactively." The remedy the insurers sought was what one seeks in a facial challenge. They did not seek to enjoin the Department from taking certain action against it on the ground the action is unconstitutional. Instead, they asked the court to "[declare] invalid the retroactive provision of the Act on the grounds that it violates [their] right to due process of law as guaranteed by the Florida Constitution . . ." and "enjoining retroactive enforcement of the Act." The retroactivity provision is plainly the enactment that the insurers challenged. I submit that this claim is a valid facial challenge.

Moreover, the Florida Supreme Court has allowed facial challenges specifically to the retroactive application of new statutory provisions. For instance, in *Maronda Homes, Inc. of Florida v. Lakeview Reserve Homeowners Ass'n, Inc.*, 127 So. 3d 1258, 1272 (Fla. 2013), the plaintiffs challenged the retroactive application of a newly-enacted statute that would preclude relief if applied to their case. The court did not consider whether the plaintiffs brought a facial or as-applied challenge to the retroactivity of a statute, but only whether retroactivity would violate due process. *Id.* at 1275-76 (holding that "section 553.835 does not apply to any causes of action that accrued before the

[1] "A facial challenge, as distinguished from an as-applied challenge, seeks to invalidate a statute or regulation itself." *United States v. Frandsen*, 212 F.3d 1231, 1235 (11th Cir. 2000).

effective date of this section" as the "retroactive application of section 553.835 would offend due process because . . . [it] would abolish actions that have accrued under the common law"). The court again allowed a challenge to the retroactive application of a new law, this time regarding insurance policies, in *Menendez v. Progressive Exp. Ins. Co., Inc.*, 35 So. 3d 873, 875 (Fla. 2010): "Because we conclude that the 2001 amendment . . . constitutes a substantive change to the statute, we hold that it cannot be retroactively applied to insurance policies issued before the effective date of the amendment" despite its legislative intent to be applied retroactively. The issue here is whether the Act should "apply retroactively," as the Legislature explicitly directed in the Act itself. The insurers label their challenge "a facial challenge to the retroactive application of the Act," and I would find that it was a valid facial challenge.

2. Retroactive application – in general

The Florida Supreme Court has generally discussed the due-process implications of statutes intended to apply retroactively as follows:

> Article I, section 2, of the Florida Constitution guarantees to all persons the right to acquire, possess, and protect property. Section 9 of article I provides that "[n]o person shall be deprived of life, liberty or property without due process of law." These constitutional due process rights protect individuals from the retroactive application of a substantive law that adversely affects or destroys a vested right; imposes or creates a new obligation or duty in connection with a previous transaction or consideration; or imposes new penalties. For the retroactive application of a law to be constitutionally permissible, the Legislature must express a clear intent that the law apply retroactively, and the law must be procedural or remedial in nature.
>
> Remedial statutes operate to further a remedy or confirm rights that already exist, and a procedural law provides the means and methods for the application and enforcement of existing duties and rights. In contrast, a substantive law prescribes legal duties and rights and,

> once those rights and duties are vested, due process prevents the Legislature from retroactively abolishing or curtailing them.

Maronda Homes, 127 So. 3d at 1272 (citations omitted).

The Legislature plainly intended for the Law to apply retroactively. However, even with such expressed intent, we still have an obligation to "determine whether retroactive application would violate any constitutional principles." *Menendez*, 35 So. 3d at 877.

3. Substantive vs. remedial legislation

I agree with the majority that the distinction between substantive and remedial legislation, which courts have drawn to determine whether the legislation can be applied retroactively, is not a simple one to apply. The majority concludes that the Act is remedial——and therefore may be applied retroactively—because it was enacted to "formally rectify industry practices harmful to consumers." Maj. op. at 9. I respectfully disagree that this fact makes the statute "remedial" for the purpose of retroactive application. Presumably, all new laws are "remedial" in the sense that they intend to rectify a perceived problem. I do not believe that this broad definition is appropriate for determining whether a law can be applied retroactively. For this purpose, remedial statutes "operate to further a remedy or confirm rights that already exist[.]" *Maronda*, 127 So. 3d at 1272. Put another way, "[r]emedial statutes or statutes relating to remedies or modes of procedure, which do not create new or take away vested rights, but only operate in furtherance of the remedy or confirmation of rights already existing," may be applied retroactively. *E. Airlines v. Planet-Reliance Ins. Co.*, 695 So. 2d 732, 734 (Fla. 1st DCA 1996) (quoting *City of Lakeland v. Catinella*, 129 So. 2d 133, 136 (Fla. 1961)). The Act simply imposes new requirements on insurers and alters when insurance proceeds escheat to the State. It has nothing to do with remedies or modes of procedure.[2] The fact that the Act

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[2] It should be noted that this Court rejected its declaratory statement that directed when insurance funds are "due and payable" under section 717.107(1), and the extent of an insurer's duty "to use due diligence in searching databases" to determine if

may have been intended to rectify industry practices deemed harmful to consumers does not make it "remedial."[3]

A law is not remedial and will not be given retroactive effect, even if expressly labeled as retroactive, if it impairs vested rights, creates new obligations, or imposes new penalties.[4] *See Menendez*, 35 So. 3d at 878-80 (holding that an amendment to a PIP statute was substantive and could not apply retroactively (although the legislature intended it to be) because it attached new legal consequences to pre-existing policies, specifically by imposing a penalty, implicating attorney's fees, granting additional time for payment, and delaying an insured's right to bring suit); *State Farm Mut. Auto. Ins. Co. v. Laforet*, 658 So. 2d 55, 61 (Fla. 1995) (holding that an amendment altering bad-faith damages could not be applied retroactively even though argued to be "simply a remedial

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insureds had died. *See Thrivent Fin. for Lutherans v. State, Dep't of Fin. Servs.*, 145 So. 3d 178, 181 (Fla. 1st DCA 2014). This Court found that the Department's interpretation was "clearly erroneous," and concluded that nothing in the plain language of section 717.107 supported either contention. *Id.* at 181-82. As such, the Act establishes new requirements and does not confirm rights that already existed.

[3] Even though this case concerns requirements imposed on insurers to ensure that policy proceeds go to their intended beneficiaries, the statute at issue is in the chapter concerning unclaimed property. I also disagree that any law regarding the disposition of unclaimed property, no matter what it requires, may be applied retroactively because unclaimed-property laws are remedial. The majority cites *Yee v. Am. Nat'l Ins. Co.*, 185 Cal. Rptr. 3d 363, 365 (Cal. Ct. App. 2015) and *Comptroller of Treasury v. PHH Corp.*, 717 A.2d 950, 952 (Md. Ct. Spec. App. 1998), for the proposition that unclaimed property laws are remedial. However, neither of these cases hold that new laws regarding unclaimed property may be applied retroactively because they are "remedial."

[4] While the *Menendez* opinion uses broad language that suggests that any statute that imposes a "new obligation" cannot be imposed retroactively, the principle clearly relates more narrowly to "new legal consequences" to existing insurance policies. *Menendez*, 35 So. 3d at 877.

clarification of legislative intent" because it significantly altered damages). *Cf. Rustic Lodge v. Escobar*, 729 So. 2d 1014, 1015 (Fla. 1st DCA 1999) (noting that "[r]emedial statutes simply confer or change a remedy in furtherance of existing rights and do not deny a [party] his or her vested rights").

At the least, the Act creates a new legal consequence upon existing policies, by a new and accelerated escheat obligation (five years after death), which applies even where insurers were unaware of insureds' deaths, effectively eliminating the dormancy period in these cases. The other requirements of the Act, specifically 1) a DMF search of all policies in effect at any time since 1992—including accounting for variations in search data, *see* section 717.107(8)(c)—and subsequent annual searches; and 2) completion and documentation of efforts to locate and contact beneficiaries and send policy information within 120 days of learning of an insured's death, present a much closer question. I agree that the majority makes a compelling argument that these requirements do not relate in any way to the insurers' obligations under the policies. Rather, they simply place obligations on the insurer to ensure that its policy is carried out. However, I agree with the trial court, which found persuasive an unpublished Kentucky appellate decision, *United Ins. Co. of Am. v. Com., Dept. of Ins.*, 2013-CA-000612-MR, 2014 WL 3973160 (Ky. Ct. App. Aug. 15, 2014), that found that a law's similar search-and-notification obligations were new and made the law substantive, "shift[ed] the burden of obtaining evidence of death and locating beneficiaries from the insured's beneficiaries and estate to the insurer," and thus could not be applied retroactively. I recognize that the Kentucky law did not state that it was to be applied retroactively, but find that this difference does not save the Florida law.[5] In

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[5] *See also Biogen IDEC MA, Inc. v. Treasurer & Receiver Gen.*, 908 N.E.2d 740, 753 (Mass. 2009) (rejecting the state's argument—that the regulation was not substantive and could apply retroactively as the business had no right to unclaimed funds—because the regulation would make the business liable for the funds while the prior regulation would not); *A.W. Fin. Services, S.A. v. Empire Res., Inc.*, 981 A.2d 1114, 1120 (Del. 2009) (holding that the "Escheat Statute" shortening the dormancy period was

summary, the Act plainly sets forth new obligations for insurers, and thus is substantive.

4. Impairment of vested rights and attachment of new obligations

I also disagree that retroactive application of the Act does not violate due process because it neither impairs vested rights nor attaches new obligations or penalties to events completed before its enactment.

> [E]ven where the Legislature has expressly stated that a statute will have retroactive application, this Court will reject such an application if the statute impairs a vested right, creates a new obligation, or imposes a new penalty. Therefore, the central focus of this Court's inquiry is whether retroactive application of the statute "attaches new legal consequences to events completed before its enactment." In order to answer this question, we compare [the statute] as it existed at the time the insureds' insurance policy was issued with the [] amendment.

Menendez, 35 So. 3d at 877-78 (citations and footnote omitted); *see also Coventry First, LLC v. State, Office of Ins. Regulation*, 30 So. 3d 552, 558 (Fla. 1st DCA 2010) (finding that the legislature intended the statute to have retroactive effect, but holding it could not be so applied because it impaired vested rights). Substantive amendments "may have retroactive effect if constitutionally permissible." *Lakeland Reg'l Med. Ctr., Inc. v. State, Agency for Healthcare Admin.*, 917 So. 2d 1024, 1031 (Fla. 1st DCA 2006) (permitting retroactive application because the right impaired by the legislation—destroying hospital's pending administrative challenge to another hospital's license issuance—was not a vested right, thus due process was not violated); *see also Metro. Dade Cty.*, 737 So. 2d at 499 ("[T]he court must ask whether the new provision attaches new legal consequences to events completed before its enactment.") (quoting *Landgraf v. USI Film Products*, 511 U.S. 244, 269-70 (1994)).

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substantive because it divested the company of its ownership rights two years earlier than previously permitted).

Here, the question is not whether the Act impairs vested rights, but whether it either creates new obligations or imposes new penalties for events completed before its enactment. When applied to policies where the insured died before the effective date, the Act clearly does. The more difficult question concerns policies where the insured was still alive at the time of enactment. When, for the purpose of permitting new obligations or imposing new penalties, is the transaction or event completed or the consideration is past—at the point the policy is issued, when the insured dies and the policy is no longer in force, or only when the insurer pays out the insurance proceeds?

There is little precedent on when an insurance contract becomes a "previous transaction or consideration" or "an event completed." The Department argues that because these are life insurance policies, they cannot be completed until the insured dies and the insurance proceeds are paid out or remitted, but cites no precedent for this point. The insurers point to *Menendez*, which determined that the new amendment's retroactivity analysis was to be compared to the automobile "insurance policy issued prior to the enactment of the statute," continuing as follows:

> In our analysis, we look at the date the insurance policy was issued and not the date that the suit was filed or the accident occurred, because "the statute in effect at the time an insurance contract is executed governs substantive issues arising in connection with that contract." *Hassen v. State Farm Mut. Auto. Ins. Co.*, 674 So. 2d 106, 108 (Fla. 1996); *see also Lumbermens Mut. Cas. Co. v. Ceballos*, 440 So. 2d 612, 613 (Fla. 3d DCA 1983) (holding that a liability policy is governed by the law in effect at the time the policy is issued, not the law in effect at the time a claim arises); *Hausler v. State Farm Mut. Auto. Ins. Co.*, 374 So. 2d 1037, 1038 (Fla. 2d DCA 1979) (holding that the date of the accident does not determine the law that is applicable to a dispute).

35 So. 3d at 876.

In *Florida Ins. Guar. Ass'n, Inc. v. Devon Neighborhood Ass'n, Inc.*, the supreme court also found that the time the policy issued was the relevant time for retroactive application in the context of

commercial residential insurance. 67 So. 3d 187, 197 (Fla. 2011) (holding that "the 2005 amendments may not be applied retroactively to the 2004 policy of insurance in this case").

Although life insurance policies are different from automobile and residential insurance policies, the rationale in *Menendez* and *Devon Neighborhood*—that an insurance policy is completed when it is executed in reliance on current laws—is equally applicable. Thus, the transaction is completed at execution in compliance with current laws and any subsequent incidents are governed by the policy, absent a valid retroactive statutory amendment. There is logic to the contention that a life insurance policy could not be completed until the insured dies and the insurer pays proceeds, as the Department argues. But that logic would also indicate that an auto insurance policy is not completed until the term expires (or, an accident results in a claim and settlement). *Menendez*, in contrast, explicitly looked at the date of execution.

5. Specific statutory requirements

a. Search and Contact Obligations

The majority claims the Act's search and contact requirements are not dissimilar to those of FDUPA prior to the Act. However, the only "due diligence requirements" prior to the Act concerned property presumed unclaimed (i.e., after the dormancy period expired) and years after the insurer became aware of the death or the insured reached the limiting age. The Act imposes search requirements on all policies where the dormancy period has not been triggered. The Act requires insurers to search the DMF for all policies in effect at any time after 1992, which the insurers contend is a prohibitive period of time, to identify the small percentage where they did not receive knowledge or proof of death.

Additionally, retroactive effect is barred if the law "imposes or creates a new obligation or duty in connection with a previous transaction *or consideration*[.]" *Maronda*, 127 So. 3d at 1272 (emphasis added). All premiums are set when the policy is issued and cannot be increased afterwards. Additionally, the Act specifically prohibited insurers from charging insureds (or beneficiaries, etc.) "any fees or costs associated with any search,

verification, claim, or delivery of funds conducted pursuant to this section"—i.e., the Act's new requirements. § 717.107(11), Fla. Stat. I find that the Act's imposition of new obligations is in connection with previous consideration—all policies where premiums were set based on pre-Act obligations—and may not be applied retroactively.

b. Escheat Obligations

Prior to the Act, FDUPA stated that funds become due and payable (i.e., the dormancy trigger) "as established from the records of the insurance company holding or owing the funds," unless one of the exceptions (e.g., if the "company knows that the insured or annuitant has died") applies. § 717.107(1)&(3), Fla. Stat. (2015). Life insurance contracts were and are statutorily required to provide that "when a policy becomes a claim by the death of the insured, settlement shall be made upon receipt of due proof of death and surrender of the policy." § 627.461, Fla. Stat. Finding the Department's argument to the contrary "clearly erroneous," this Court concluded the following in *Thrivent Fin. for Lutherans v. State, Dep't of Fin. Servs.*, 145 So. 3d 178, 181 (Fla. 1st DCA 2014):

> Life insurance funds become "due and payable" under subsection 717.107(1) at the time the insurer receives proof of death and surrender of the policy as contemplated by section 627.461; or, funds become "due and payable" under subsection 717.107(3) when the insurer knows that the insured has died, or when the insured attained or would have attained the limiting age.

145 So. 3d at 182.

The Act changed this dormancy trigger from knowledge or proof of death to "the date of death of the insured," thus property would automatically be presumed unclaimed five years after an insured's death. § 717.107(1), Fla. Stat. Retroactive application of this accelerated escheat obligation is impermissible because it applies to all policies that issued, and deaths that occurred, before the Act's enactment. The Act clearly accelerates insurers' escheat obligations, requiring them to escheat funds immediately after the Act even if they were not previously aware of an insured's death

years ago. For these reasons, I would hold that *Menendez* bars the Act's application to any policies issued before the Act's enactment. *See Menendez*, 35 So. 3d at 877-78.

c. Penalties

This Court may also affirm on the additional ground that the Act unlawfully imposes new penalties retroactively, an issue the trial court felt was unnecessary to address.[6] The parties do not appear to dispute that the Act imposes new penalties by penalizing previously lawful conduct (inaction). The Department argues the new penalties are lawful retroactively because they provide a five-year grace period for compliance and a good-faith exception (e.g., an insurer lawfully disposed of records). *See City of Miami v. St. Joe Paper Co.*, 364 So. 2d 439, 444 (Fla. 1978) ("[R]etroactive statutes have been almost universally declared constitutional when a reasonable time was given to protect property interests by complying with the new requirements. Thus, the constitutional objection that retroactive application of a statute results in a deprivation of due process is obviated where the statute gives owners of old claims still enforceable at the time of the statutory enactment a reasonable time to take certain steps to preserve their interests.").

"[C]onstitutional due process rights protect individuals from the retroactive application of a substantive law that . . . imposes new penalties." *Maronda*, 127 So. 3d at 1272. The Act's grace period precludes penalties, fines, or additional interest "due to the failure to report and remit" unclaimed property to the state so long as reporting and remittance is done within five years. Ch. 2016-219, § 2, Laws of Fla.; § 717.107, Fla. Stat. The insurers make three arguments as to penalties.

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[6] I disagree with the majority that the insurers must mount a later as-applied challenge to test the constitutionality of the penalty provision. Again, the insurers challenge only the retroactive application, which is explicitly permitted by section 2 of the Act. To the extent the penalties are applied to existing insurance policies, they are applied retroactively and a permissible part of this facial challenge.

First, the insurers argue that the grace period itself is inadequate. While it may delay penalties for reporting and remittance, it does not do so for the search and escheat obligations.

Second, the insurers argue that these new penalties are especially problematic considering that FDUPA only requires insurers to retain records for five years after property becomes reportable, and therefore they were under no duty to retain the records they are now required to search. § 717.1311, Fla. Stat.; *see also Temple-Inland, Inc. v. Cook*, 192 F. Supp. 3d 527, 545 (D. Del. 2016) (holding that the state could not, for a number of alternative reasons, require a company to escheat funds that it was not required to retain records for).

Third, the insurers argue that the presence of a grace period is insufficient. The Department relies on *St. Joe Paper Co.*, but the supreme court in that case allowed a statute of limitations (to claim title to property) to apply retroactively because the claim-owners still had an opportunity to preserve their rights after the act's enactment. 364 So. 2d at 442-44. Here, the grace period is not to allow the preservation of rights, but to get into compliance before facing new penalties for previously lawful conduct. Unlike in *St. Joe Paper Co.*, after the grace period, new penalties would be imposed for pre-amendment transactions. *See Childers v. Dep't of Envtl. Prot.*, 696 So. 2d 962, 964 (Fla. 1st DCA 1997) ("Statutes stating new grounds for administrative fines . . . or for license revocation or suspension should not be given retroactive effect.").

These reasons are sufficient to conclude that the Act imposes new obligations on previous transactions and imposes new penalties, and thus may not be applied retroactively.

For the foregoing reasons, I would hold that chapter 2016-219, Laws of Florida, cannot apply retroactively to policies executed prior to the Act, and would affirm the trial court's order reaching that conclusion.

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M. Drew Parker of Radey Law Firm, Tallahassee, and Lynden Lyman, pro hac vice, Unclaimed Property Advisor, Concord, MA, in support of Appellants by Amici Curiae the National Association of Unclaimed Property Administrators.

M. Hope Keating of Greenberg Traurig, P.A., Tallahassee; Nicole M. Ryan, pro hac vice and Carol Lynn Thompson, pro hac vice of Sidley Austin, LLP, San Francisco, CA, for Appellees.

Katherine E. Giddings and Diane G. DeWolf of Akerman, LLC, Tallahassee, in support of Appellees by Amici Curiae American Council of Life Insurers; Christine Davis Graves of Carlton Fields, Tallahassee, in support of Appellees by Amici Curiae The National Alliance of Life Companies; Thomas P. Crapps, Timothy J. Meenan, and Kirsten Matthis of Meenan, P.A., Tallahassee, in support of Appellees by Amici Curiae Florida Insurance Council; Timothy G. Schoenwalder of Meenan, P.A., Tallahassee, and Andrew B. Kay, pro hac vice and P. Randolph Seybold, pro hac vice of Venable, LLP, Washington, DC, in support of Appellees by Amici Curiae Thrivent Financial for Lutherans.

REFERENCE TITLE: annuity transactions; requirements

State of Arizona
Senate
Fifty-fourth Legislature
Second Regular Session
2020

SB 1557

Introduced by
Senator Livingston

AN ACT

AMENDING SECTIONS 20-1243 AND 20-1243.01, ARIZONA REVISED STATUTES; REPEALING SECTION 20-1243.03, ARIZONA REVISED STATUTES; AMENDING TITLE 20, CHAPTER 6, ARTICLE 1.3, ARIZONA REVISED STATUTES, BY ADDING A NEW SECTION 20-1243.03; AMENDING SECTIONS 20-1243.05, 20-1243.06 AND 20-1243.07, ARIZONA REVISED STATUTES; RELATING TO ANNUITY TRANSACTIONS.

(TEXT OF BILL BEGINS ON NEXT PAGE)

1 Be it enacted by the Legislature of the State of Arizona:
2 Section 1. Section 20-1243, Arizona Revised Statutes, is amended to
3 read:
4 20-1243. Definitions
5 In this article, unless the context otherwise requires:
6 1. "Annuity" means an annuity that is individually solicited,
7 whether the product is classified as an individual or group annuity.
8 2. "Business entity" has the same meaning prescribed in section
9 20-281.
10 ~~3. "Insurance producer" has the same meaning prescribed in section~~
11 ~~20-281.~~
12 3. "CASH COMPENSATION" MEANS ANY DISCOUNT, CONCESSION, FEE, SERVICE
13 FEE, COMMISSION, SALES CHARGE, LOAN, OVERRIDE OR CASH BENEFIT RECEIVED BY
14 A PRODUCER IN CONNECTION WITH THE RECOMMENDATION OR SALE OF AN ANNUITY
15 FROM AN INSURER OR INTERMEDIARY OR DIRECTLY FROM THE CONSUMER.
16 4. "CONSUMER PROFILE INFORMATION" MEANS INFORMATION THAT IS
17 REASONABLY APPROPRIATE TO DETERMINE WHETHER A RECOMMENDATION ADDRESSES THE
18 CONSUMER'S FINANCIAL SITUATION, INSURANCE NEEDS AND FINANCIAL OBJECTIVES,
19 INCLUDING AT LEAST ALL OF THE FOLLOWING:
20 (a) AGE.
21 (b) ANNUAL INCOME.
22 (c) FINANCIAL SITUATION AND NEEDS, INCLUDING DEBTS AND OTHER
23 OBLIGATIONS.
24 (d) FINANCIAL EXPERIENCE.
25 (e) INSURANCE NEEDS.
26 (f) FINANCIAL OBJECTIVES.
27 (g) INTENDED USE OF THE ANNUITY.
28 (h) FINANCIAL TIME HORIZON.
29 (i) EXISTING ASSETS OR FINANCIAL PRODUCERS, INCLUDING INVESTMENT,
30 ANNUITY AND INSURANCE HOLDINGS.
31 (j) LIQUIDITY NEEDS.
32 (k) LIQUID NET WORTH.
33 (l) RISK TOLERANCE, INCLUDING WILLINGNESS TO ACCEPT NONGUARANTEED
34 ELEMENTS IN THE ANNUITY.
35 (m) FINANCIAL RESOURCES USED TO FUND THE ANNUITY.
36 (n) TAX STATUS.
37 5. "CONTINUING EDUCATION CREDIT" MEANS ONE CONTINUING EDUCATION
38 CREDIT HOUR AS DEFINED IN SECTION 20-2901.
39 6. "CONTINUING EDUCATION PROVIDER" MEANS AN INDIVIDUAL OR ENTITY
40 THAT IS APPROVED TO OFFER CONTINUING EDUCATION COURSES PURSUANT TO CHAPTER
41 18 OF THIS TITLE.
42 7. "FINRA" MEANS THE FINANCIAL INDUSTRY REGULATORY AUTHORITY OR A
43 SUCCEEDING AGENCY.
44 ~~4.~~ 8. "Insurer" has the same meaning prescribed in section 20-104.

1 9. "INTERMEDIARY" MEANS AN ENTITY THAT IS CONTRACTED DIRECTLY WITH
2 AN INSURER OR WITH ANOTHER ENTITY THAT IS CONTRACTED WITH AN INSURER TO
3 FACILITATE THE SALE OF THE INSURER'S ANNUITIES BY PRODUCERS.
4 ~~5.~~ 10. "Managing general agent" has the same meaning prescribed in
5 section 20-311.
6 11. "MATERIAL CONFLICT OF INTEREST":
7 (a) MEANS A PRODUCER'S FINANCIAL INTEREST IN THE SALE OF AN ANNUITY
8 THAT A REASONABLE PERSON WOULD EXPECT TO INFLUENCE THE IMPARTIALITY OF THE
9 PRODUCER'S RECOMMENDATION.
10 (b) DOES NOT INCLUDE CASH COMPENSATION OR NONCASH COMPENSATION.
11 12. "NONCASH COMPENSATION" MEANS ANY FORM OF COMPENSATION THAT IS
12 NOT CASH COMPENSATION, INCLUDING HEALTH INSURANCE, OFFICE RENT, OFFICE
13 SUPPORT AND RETIREMENT BENEFITS.
14 13. "NONGUARANTEED ELEMENTS" MEANS THE PREMIUMS, CREDITED INTEREST
15 RATES INCLUDING ANY BONUS, BENEFITS, VALUES, DIVIDENDS, NONINTEREST BASED
16 CREDITS, CHARGES OR ELEMENTS OF FORMULAS USED TO DETERMINE ANY OF THESE
17 THAT ARE SUBJECT TO COMPANY DISCRETION AND ARE NOT GUARANTEED AT ISSUE.
18 AN ELEMENT IS CONSIDERED NONGUARANTEED IF ANY OF THE UNDERLYING
19 NONGUARANTEED ELEMENTS ARE USED IN ITS CALCULATION.
20 14. "PRODUCER":
21 (a) MEANS AN INSURANCE PRODUCER AS DEFINED IN SECTION 20-281.
22 (b) INCLUDES AN INSURER WHERE NO PRODUCER IS INVOLVED.
23 ~~6.~~ 15. "Recommendation":
24 (a) Means advice provided by ~~an insurance~~ A producer~~, or an insurer~~
25 ~~if no producer is involved,~~ to an individual consumer that ~~results~~ WAS
26 INTENDED TO RESULT OR DOES RESULT in a purchase, ~~or~~ exchange OR
27 REPLACEMENT of an annuity pursuant to that advice.
28 (b) DOES NOT INCLUDE GENERAL COMMUNICATION TO THE PUBLIC,
29 GENERALIZED CUSTOMER SERVICE ASSISTANCE OR ADMINISTRATIVE SUPPORT, GENERAL
30 EDUCATION INFORMATION AND TOOLS, PROSPECTUSES OR OTHER PRODUCT AND SALES
31 MATERIALS.
32 16. "REPLACEMENT" MEANS A TRANSACTION IN WHICH A NEW ANNUITY IS TO
33 BE PURCHASED AND IT IS KNOWN OR SHOULD BE KNOWN TO THE PROPOSING PRODUCER
34 OR TO THE PROPOSING INSURER, WHETHER OR NOT A PRODUCER IS INVOLVED, THAT
35 BY REASON OF THE TRANSACTION, AN EXISTING ANNUITY OR OTHER INSURANCE
36 POLICY HAS BEEN OR IS TO BE ANY OF THE FOLLOWING:
37 (a) LAPSED, FORFEITED, SURRENDERED OR PARTIALLY SURRENDERED,
38 ASSIGNED TO THE REPLACING INSURER OR OTHERWISE TERMINATED.
39 (b) CONVERTED TO REDUCED PAID-UP INSURANCE, CONTINUED AS EXTENDED
40 TERM INSURANCE OR OTHERWISE REDUCED IN VALUE BY THE USE OF NONFORFEITURE
41 BENEFITS OR OTHER POLICY VALUES.
42 (c) AMENDED SO AS TO EFFECT EITHER A REDUCTION IN BENEFITS OR IN
43 THE TERM FOR WHICH COVERAGE WOULD OTHERWISE REMAIN IN FORCE OR WHICH
44 BENEFITS WOULD BE PAID.
45 (d) REISSUED WITH ANY REDUCTION IN CASH VALUE.

(e) USED IN A FINANCED PURCHASE.

17. "SEC" MEANS THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION.

Sec. 2. Section 20-1243.01, Arizona Revised Statutes, is amended to read:

20-1243.01. Scope and limitation of article

A. This article applies to any SALE OR recommendation ~~to purchase or exchange~~ OF an annuity ~~that is made to a consumer by an insurance producer, or an insurer if no producer is involved, that results in the recommended purchase or exchange~~.

B. ~~Nothing in~~ This article ~~shall be construed to~~ DOES NOT:

1. Affect in any manner any provision of title 44, chapters 12 and 13.

2. CREATE OR IMPLY A PRIVATE CAUSE OF ACTION FOR A VIOLATION OF THIS ARTICLE OR SUBJECT A PRODUCER TO CIVIL LIABILITY UNDER THE BEST INTEREST STANDARD OF CARE PRESCRIBED IN SECTION 20-1243.03 OR UNDER STANDARDS THAT GOVERN THE CONDUCT OF A FIDUCIARY OR FIDUCIARY RELATIONSHIP.

Sec. 3. Repeal

Section 20-1243.03, Arizona Revised Statutes, is repealed.

Sec. 4. Title 20, chapter 6, article 1.3, Arizona Revised Statutes, is amended by adding a new section 20-1243.03, to read:

20-1243.03. Duties of insurers and producers; definitions

A. WHEN A PRODUCER MAKES A RECOMMENDATION OF AN ANNUITY, THE PRODUCER SHALL ACT IN THE BEST INTEREST OF THE CONSUMER UNDER THE CIRCUMSTANCES KNOWN AT THE TIME THE RECOMMENDATION IS MADE, WITHOUT PLACING THE PRODUCER'S OR THE INSURER'S FINANCIAL INTEREST AHEAD OF THE CONSUMER'S INTEREST. THE PRODUCER HAS ACTED IN THE BEST INTEREST OF THE CONSUMER IF THE PRODUCER HAS SATISFIED THE OBLIGATIONS REGARDING CARE, DISCLOSURE, CONFLICT OF INTEREST AND DOCUMENTATION PRESCRIBED IN THIS SECTION.

B. IN MAKING A RECOMMENDATION, THE PRODUCER SHALL EXERCISE REASONABLE DILIGENCE, CARE AND SKILL TO DO ALL OF THE FOLLOWING:

1. KNOW THE CONSUMER'S FINANCIAL SITUATION, INSURANCE NEEDS AND FINANCIAL OBJECTIVES.

2. UNDERSTAND THE AVAILABLE RECOMMENDATION OPTIONS AFTER MAKING A REASONABLE INQUIRY INTO OPTIONS AVAILABLE TO THE PRODUCER.

3. HAVE A REASONABLE BASIS TO BELIEVE BOTH OF THE FOLLOWING:

(a) THE RECOMMENDED OPTION EFFECTIVELY ADDRESSES THE CONSUMER'S FINANCIAL SITUATION, INSURANCE NEEDS AND FINANCIAL OBJECTIVES OVER THE LIFE OF THE PRODUCT, AS EVALUATED IN LIGHT OF THE CONSUMER PROFILE INFORMATION. THE REQUIREMENTS UNDER THIS SUBDIVISION INCLUDE MAKING REASONABLE EFFORTS TO OBTAIN CONSUMER PROFILE INFORMATION FROM THE CONSUMER BEFORE RECOMMENDING AN ANNUITY.

1 (b) THE CONSUMER WOULD BENEFIT FROM CERTAIN FEATURES OF THE
2 ANNUITY, SUCH AS ANNUITIZATION, DEATH OR LIVING BENEFITS OR OTHER
3 INSURANCE-RELATED FEATURES.
4 4. CONSIDER THE TYPES OF PRODUCTS THE PRODUCER IS AUTHORIZED AND
5 LICENSED TO RECOMMEND OR SELL THAT ADDRESS THE CONSUMER'S FINANCIAL
6 SITUATION, INSURANCE NEEDS AND FINANCIAL OBJECTIVES. THE PRODUCER:
7 (a) IS NOT REQUIRED TO ANALYZE OR CONSIDER ANY PRODUCT OUTSIDE THE
8 PRODUCER'S AUTHORITY AND LICENSE OR OTHER POSSIBLE ALTERNATIVE PRODUCTS OR
9 STRATEGIES THAT ARE AVAILABLE IN THE MARKET AT THE TIME OF RECOMMENDATION.
10 (b) SHALL BE HELD TO THE SAME STANDARDS THAT APPLY TO PRODUCERS
11 WITH SIMILAR AUTHORITY AND LICENSURE.
12 5. IN THE CASE OF AN EXCHANGE OR REPLACEMENT OF AN ANNUITY,
13 CONSIDER THE WHOLE TRANSACTION, INCLUDING TAKING INTO CONSIDERATION
14 WHETHER:
15 (a) THE CONSUMER WILL INCUR A SURRENDER CHARGE, BE SUBJECT TO THE
16 COMMENCEMENT OF A NEW SURRENDER PERIOD, LOSE EXISTING BENEFITS, SUCH AS
17 DEATH, LIVING OR OTHER CONTRACTUAL BENEFITS, OR BE SUBJECT TO INCREASED
18 FEES, INVESTMENT ADVISORY FEES OR CHARGES FOR RIDERS AND SIMILAR PRODUCT
19 ENHANCEMENTS.
20 (b) THE REPLACING PRODUCT WOULD SUBSTANTIALLY BENEFIT THE CONSUMER
21 IN COMPARISON TO THE REPLACED PRODUCT OVER THE LIFE OF THE PRODUCT.
22 (c) THE CONSUMER HAS HAD ANOTHER ANNUITY EXCHANGE OR REPLACEMENT
23 AND, IN PARTICULAR, AN EXCHANGE OR REPLACEMENT WITHIN THE PRECEDING SIXTY
24 MONTHS.
25 C. THE REQUIREMENTS UNDER THIS SECTION:
26 1. DO NOT CREATE A FIDUCIARY OBLIGATION OR RELATIONSHIP AND ONLY
27 CREATE A REGULATORY OBLIGATION AS ESTABLISHED IN THIS SECTION.
28 2. APPLY TO THE PARTICULAR ANNUITY AS A WHOLE AND THE UNDERLYING
29 SUBACCOUNTS TO WHICH FUNDS ARE ALLOCATED AT THE TIME OF PURCHASE OR
30 EXCHANGE OF AN ANNUITY, AND RIDERS AND SIMILAR PRODUCT ENHANCEMENTS, IF
31 ANY.
32 3. DO NOT MEAN THE ANNUITY WITH THE LOWEST ONETIME OR MULTIPLE
33 OCCURRENCE COMPENSATION STRUCTURE SHALL NECESSARILY BE RECOMMENDED.
34 4. DO NOT MEAN THE PRODUCER HAS ONGOING MONITORING OBLIGATIONS
35 UNDER THE CARE OBLIGATION UNDER SUBSECTION B OF THIS SECTION, ALTHOUGH
36 SUCH AN OBLIGATION MAY BE SEPARATELY OWED UNDER THE TERMS OF A FIDUCIARY,
37 CONSULTING, INVESTMENT ADVISING OR FINANCIAL PLANNING AGREEMENT BETWEEN
38 THE CONSUMER AND THE PRODUCER.
39 5. DO NOT REQUIRE A PRODUCER TO OBTAIN ANY LICENSE OTHER THAN A
40 PRODUCER LICENSE WITH THE APPROPRIATE LINE OF AUTHORITY TO SELL, SOLICIT
41 OR NEGOTIATE INSURANCE IN THIS STATE, INCLUDING ANY SECURITIES LICENSE, IN
42 ORDER TO FULFILL THE DUTIES AND OBLIGATIONS CONTAINED IN THIS ARTICLE IF
43 THE PRODUCER DOES NOT GIVE ADVICE OR PROVIDE SERVICES THAT ARE OTHERWISE
44 SUBJECT TO SECURITIES LAWS OR ENGAGE IN ANY OTHER ACTIVITY REQUIRING OTHER
45 PROFESSIONAL LICENSES.

1 D. THE CONSUMER PROFILE INFORMATION, CHARACTERISTICS OF THE INSURER
2 AND PRODUCT COSTS, RATES, BENEFITS AND FEATURES ARE THOSE FACTORS
3 GENERALLY RELEVANT IN MAKING A DETERMINATION WHETHER AN ANNUITY
4 EFFECTIVELY ADDRESSES THE CONSUMER'S FINANCIAL SITUATION, INSURANCE NEEDS
5 AND FINANCIAL OBJECTIVES, BUT THE LEVEL OF IMPORTANCE OF EACH FACTOR UNDER
6 THE CARE OBLIGATION UNDER SUBSECTION B OF THIS SECTION MAY VARY DEPENDING
7 ON THE FACTS AND CIRCUMSTANCES OF A PARTICULAR CASE, AND EACH FACTOR MAY
8 NOT BE CONSIDERED IN ISOLATION.
9 E. BEFORE THE RECOMMENDATION OR SALE OF AN ANNUITY, THE PRODUCER
10 SHALL PROMINENTLY DISCLOSE THE FOLLOWING INFORMATION TO THE CONSUMER ON A
11 FORM SUBSTANTIALLY SIMILAR TO THE "INSURANCE AGENT (PRODUCER) DISCLOSURE
12 FOR ANNUITIES" FORM IN APPENDIX A OF THE 2020 NATIONAL ASSOCIATION OF
13 INSURANCE COMMISSIONERS SUITABILITY IN ANNUITY TRANSACTIONS MODEL
14 REGULATION:
15 1. A DESCRIPTION OF THE SCOPE AND TERMS OF THE RELATIONSHIP WITH
16 THE CONSUMER AND THE ROLE OF THE PRODUCER IN THE TRANSACTION.
17 2. AN AFFIRMATIVE STATEMENT ON WHETHER THE PRODUCER IS LICENSED AND
18 AUTHORIZED TO SELL THE FOLLOWING PRODUCTS:
19 (a) FIXED ANNUITIES.
20 (b) FIXED INDEXED ANNUITIES.
21 (c) VARIABLE ANNUITIES.
22 (d) LIFE INSURANCE.
23 (e) MUTUAL FUNDS.
24 (f) STOCKS AND BONDS.
25 (g) CERTIFICATES OF DEPOSIT.
26 3. AN AFFIRMATIVE STATEMENT DESCRIBING THE INSURERS FOR WHICH THE
27 PRODUCER IS AUTHORIZED, CONTRACTED OR APPOINTED OR OTHERWISE ABLE TO SELL
28 INSURANCE PRODUCTS, USING THE FOLLOWING DESCRIPTIONS:
29 (a) ONE INSURER.
30 (b) FROM TWO OR MORE INSURERS.
31 (c) FROM TWO OR MORE INSURERS ALTHOUGH PRIMARILY CONTRACTED WITH
32 ONE INSURER.
33 4. A DESCRIPTION OF THE SOURCES AND TYPES OF CASH COMPENSATION AND
34 NONCASH COMPENSATION TO BE RECEIVED BY THE PRODUCER, INCLUDING WHETHER THE
35 PRODUCER IS TO BE COMPENSATED FOR THE SALE OF A RECOMMENDED ANNUITY BY
36 COMMISSION AS PART OF A PREMIUM OR OTHER REMUNERATION RECEIVED FROM THE
37 INSURER, INTERMEDIARY OR OTHER PRODUCER OR BY FEE AS A RESULT OF A
38 CONTRACT FOR ADVICE OR CONSULTING SERVICES.
39 5. A NOTICE OF THE CONSUMER'S RIGHT TO REQUEST ADDITIONAL
40 INFORMATION REGARDING CASH COMPENSATION. ON REQUEST OF THE CONSUMER OR
41 THE CONSUMER'S DESIGNATED REPRESENTATIVE, THE PRODUCER SHALL DISCLOSE BOTH
42 OF THE FOLLOWING:
43 (a) A REASONABLE ESTIMATE OF THE AMOUNT OF CASH COMPENSATION TO BE
44 RECEIVED BY THE PRODUCER, WHICH MAY BE STATED AS A RANGE OF AMOUNTS OR
45 PERCENTAGES.

1 (b) WHETHER THE CASH COMPENSATION IS A ONETIME OR MULTIPLE
2 OCCURRENCE AMOUNT. IF THE CASH COMPENSATION IS A MULTIPLE OCCURRENCE
3 AMOUNT, THE PRODUCER SHALL DISCLOSE THE FREQUENCY AND AMOUNT OF THE
4 OCCURRENCE, WHICH MAY BE STATED AS A RANGE OF AMOUNTS OR PERCENTAGES.
5 F. BEFORE OR AT THE TIME OF THE RECOMMENDATION OR SALE OF AN
6 ANNUITY, THE PRODUCER SHALL HAVE A REASONABLE BASIS TO BELIEVE THE
7 CONSUMER HAS BEEN INFORMED OF VARIOUS FEATURES OF THE ANNUITY, SUCH AS THE
8 POTENTIAL SURRENDER PERIOD AND SURRENDER CHARGE, POTENTIAL TAX PENALTY IF
9 THE CONSUMER SELLS, EXCHANGES, SURRENDERS OR ANNUITIZES THE ANNUITY,
10 MORTALITY AND EXPENSE FEES, INVESTMENT ADVISORY FEES, ANY ANNUAL FEES,
11 POTENTIAL CHARGES FOR AND FEATURES OF RIDERS OR OTHER OPTIONS OF THE
12 ANNUITY, LIMITS ON INTEREST RETURNS, POTENTIAL CHANGES IN NONGUARANTEED
13 ELEMENTS OF THE ANNUITY, INSURANCE AND INVESTMENT COMPONENTS AND MARKET
14 RISK.
15 G. THE PRODUCER SHALL IDENTIFY AND AVOID OR REASONABLY MANAGE AND
16 DISCLOSE MATERIAL CONFLICTS OF INTEREST, INCLUDING MATERIAL CONFLICTS OF
17 INTEREST RELATED TO AN OWNERSHIP INTEREST.
18 H. THE PRODUCER AT THE TIME OF RECOMMENDATION OR SALE SHALL:
19 1. MAKE A WRITTEN RECORD OF ANY RECOMMENDATION AND THE BASIS FOR
20 THE RECOMMENDATION SUBJECT TO THIS ARTICLE.
21 2. OBTAIN A CONSUMER-SIGNED STATEMENT ON A FORM SUBSTANTIALLY
22 SIMILAR TO "THE CONSUMER REFUSAL TO PROVIDE INFORMATION" FORM IN APPENDIX
23 B OF 2020 NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS SUITABILITY IN
24 ANNUITY TRANSACTIONS MODEL REGULATION DOCUMENTING BOTH:
25 (a) A CUSTOMER'S REFUSAL TO PROVIDE THE CONSUMER PROFILE
26 INFORMATION, IF ANY.
27 (b) A CUSTOMER'S UNDERSTANDING OF THE RAMIFICATION OF NOT PROVIDING
28 THE CONSUMER PROFILE INFORMATION OR PROVIDING INSUFFICIENT CONSUMER
29 PROFILE INFORMATION.
30 3. OBTAIN A CONSUMER-SIGNED STATEMENT ON A FORM SUBSTANTIALLY
31 SIMILAR TO THE "CONSUMER DECISION TO PURCHASE AN ANNUITY NOT BASED ON A
32 RECOMMENDATION" FORM IN APPENDIX C OF THE 2020 NATIONAL ASSOCIATION OF
33 INSURANCE COMMISSIONERS SUITABILITY IN ANNUITY TRANSACTIONS MODEL
34 REGULATION ACKNOWLEDGING THE ANNUITY TRANSACTION IS NOT RECOMMENDED IF A
35 CUSTOMER DECIDES TO ENTER INTO AN ANNUITY TRANSACTION THAT IS NOT BASED ON
36 THE PRODUCER'S RECOMMENDATION.
37 I. ANY REQUIREMENT APPLICABLE TO A PRODUCER UNDER THIS SECTION
38 APPLIES TO EVERY PRODUCER WHO HAS EXERCISED MATERIAL CONTROL OR INFLUENCE
39 IN THE MAKING OF A RECOMMENDATION AND HAS RECEIVED DIRECT COMPENSATION AS
40 A RESULT OF THE RECOMMENDATION OR SALE, REGARDLESS OF WHETHER THE PRODUCER
41 HAS HAD ANY DIRECT CONTACT WITH THE CONSUMER. ACTIVITIES SUCH AS THE
42 FOLLOWING DO NOT IN AND OF THEMSELVES CONSTITUTE MATERIAL CONTROL OR
43 INFLUENCE:
44 1. PROVIDING OR DELIVERING MARKETING OR EDUCATIONAL MATERIAL.
45 2. PRODUCT WHOLESALING OR OTHER BACK-OFFICE PRODUCT SUPPORT.

1 3. GENERAL SUPERVISION OF A PRODUCER.
2 J. AN INSURER'S ISSUANCE OF AN ANNUITY SUBJECT TO THIS SUBSECTION
3 SHALL BE REASONABLE UNDER ALL THE CIRCUMSTANCES ACTUALLY KNOWN TO THE
4 INSURER AT THE TIME THE ANNUITY IS ISSUED. A PRODUCER HAS NO OBLIGATION
5 TO A CONSUMER RELATED TO AN ANNUITY TRANSACTION IF:
6 1. NO RECOMMENDATION IS MADE.
7 2. A RECOMMENDATION WAS MADE THAT WAS LATER FOUND TO HAVE BEEN
8 PREPARED BASED ON MATERIALLY INACCURATE INFORMATION PROVIDED BY THE
9 CONSUMER.
10 3. THE CONSUMER REFUSES TO PROVIDE RELEVANT CONSUMER PROFILE
11 INFORMATION AND THE ANNUITY TRANSACTION IS NOT RECOMMENDED.
12 4. THE CONSUMER DECIDES TO ENTER INTO AN ANNUITY TRANSACTION THAT
13 IS NOT BASED ON A RECOMMENDATION BY THE PRODUCER.
14 K. EXCEPT AS ALLOWED UNDER SUBSECTION J OF THIS SECTION, AN INSURER
15 MAY NOT ISSUE AN ANNUITY RECOMMENDED TO A CONSUMER UNLESS THERE IS A
16 REASONABLE BASIS TO BELIEVE THE ANNUITY WOULD EFFECTIVELY ADDRESS THE
17 PARTICULAR CONSUMER'S FINANCIAL SITUATION, INSURANCE NEEDS AND FINANCIAL
18 OBJECTIVES BASED ON THE CONSUMER'S CONSUMER PROFILE INFORMATION. EACH
19 INSURER SHALL ESTABLISH AND MAINTAIN A SUPERVISION SYSTEM THAT IS
20 REASONABLY DESIGNED TO ACHIEVE THE INSURER'S AND ITS PRODUCERS' COMPLIANCE
21 WITH THIS ARTICLE AND THAT INCLUDES THE FOLLOWING:
22 1. REASONABLE PROCEDURES TO INFORM ITS PRODUCERS OF THE
23 REQUIREMENTS OF THIS ARTICLE, INCLUDING INCORPORATING THE REQUIREMENTS OF
24 THIS ARTICLE IN RELEVANT PRODUCER TRAINING MANUALS.
25 2. STANDARDS FOR PRODUCER PRODUCT TRAINING, INCLUDING ESTABLISHING
26 AND MAINTAINING REASONABLE PROCEDURES TO ENSURE COMPLIANCE WITH SECTION
27 20-1243.07.
28 3. PRODUCT-SPECIFIC TRAINING AND TRAINING MATERIALS THAT EXPLAIN
29 ALL MATERIAL FEATURES OF ITS ANNUITY PRODUCTS TO ITS PRODUCERS.
30 4. PROCEDURES FOR REVIEWING EACH RECOMMENDATION BEFORE ISSUING AN
31 ANNUITY THAT ARE DESIGNED TO ENSURE THERE IS A REASONABLE BASIS TO
32 DETERMINE THAT THE RECOMMENDED ANNUITY WOULD EFFECTIVELY ADDRESS THE
33 PARTICULAR CONSUMER'S FINANCIAL SITUATION, INSURANCE NEEDS AND FINANCIAL
34 OBJECTIVES. THE REVIEW PROCEDURES MAY APPLY A SCREENING SYSTEM FOR THE
35 PURPOSE OF IDENTIFYING SELECTED TRANSACTIONS FOR ADDITIONAL REVIEW AND MAY
36 BE ACCOMPLISHED ELECTRONICALLY OR THROUGH OTHER MEANS, INCLUDING PHYSICAL
37 REVIEW. THE ELECTRONIC SYSTEM OR OTHER SYSTEM MAY BE DESIGNED TO REQUIRE
38 ADDITIONAL REVIEW OF ONLY THOSE TRANSACTIONS THAT ARE IDENTIFIED FOR
39 ADDITIONAL REVIEW BY THE SELECTION CRITERIA.
40 5. REASONABLE PROCEDURES TO DETECT RECOMMENDATIONS THAT DO NOT
41 COMPLY WITH THIS SECTION, INCLUDING CONFIRMATION OF THE CONSUMER'S
42 CONSUMER PROFILE INFORMATION, SYSTEMATIC CUSTOMER SURVEYS, PRODUCER AND
43 CONSUMER INTERVIEWS, CONFIRMATION LETTERS, PRODUCER STATEMENTS OR
44 ATTESTATIONS AND PROGRAMS OF INTERNAL MONITORING. THIS PARAGRAPH DOES NOT
45 PREVENT AN INSURER FROM COMPLYING WITH THIS PARAGRAPH BY APPLYING SAMPLING

PROCEDURES OR BY CONFIRMING THE CONSUMER PROFILE INFORMATION OR OTHER REQUIRED INFORMATION UNDER THIS SECTION AFTER ISSUING OR DELIVERING THE ANNUITY.

6. REASONABLE PROCEDURES TO ASSESS, BEFORE OR ON ISSUANCE OR DELIVERY OF AN ANNUITY, WHETHER A PRODUCER HAS PROVIDED TO THE CONSUMER THE INFORMATION REQUIRED TO BE PROVIDED UNDER THIS SECTION.

7. REASONABLE PROCEDURES TO IDENTIFY AND ADDRESS SUSPICIOUS CONSUMER REFUSALS TO PROVIDE CONSUMER PROFILE INFORMATION.

8. REASONABLE PROCEDURES TO IDENTIFY AND ELIMINATE ANY SALES CONTESTS, SALES QUOTAS, BONUSES AND NONCASH COMPENSATION THAT ARE BASED ON THE SALES OF SPECIFIC ANNUITIES WITHIN A LIMITED PERIOD OF TIME. THIS PARAGRAPH DOES NOT PROHIBIT THE RECEIPT OF HEALTH INSURANCE, OFFICE RENT, OFFICE SUPPORT, RETIREMENT BENEFITS OR OTHER EMPLOYEE BENEFITS BY EMPLOYEES SO LONG AS THOSE BENEFITS ARE NOT BASED ON THE VOLUME OF SALES OF A SPECIFIC ANNUITY WITHIN A LIMITED PERIOD OF TIME.

9. A WRITTEN ANNUAL REPORT TO SENIOR MANAGEMENT, INCLUDING TO THE SENIOR MANAGER RESPONSIBLE FOR AUDIT FUNCTIONS, THAT DETAILS A REVIEW WITH APPROPRIATE TESTING AND THAT IS REASONABLY DESIGNED TO DETERMINE THE EFFECTIVENESS OF THE SUPERVISION SYSTEM, THE EXCEPTIONS FOUND AND CORRECTIVE ACTION TAKEN OR RECOMMENDED, IF ANY.

L. AN INSURER MAY CONTRACT FOR PERFORMANCE OF A FUNCTION, INCLUDING MAINTENANCE OF PROCEDURES, REQUIRED UNDER SUBSECTION K OF THIS SECTION BUT IS RESPONSIBLE FOR TAKING APPROPRIATE CORRECTIVE ACTION AND MAY BE SUBJECT TO SANCTIONS AND PENALTIES PURSUANT TO SECTION 20-1243.05 REGARDLESS OF WHETHER THE INSURER CONTRACTS FOR PERFORMANCE OF A FUNCTION AND REGARDLESS OF THE INSURER'S COMPLIANCE WITH PARAGRAPH 2 OF THIS SUBSECTION. AN INSURER'S SUPERVISION SYSTEM SHALL INCLUDE SUPERVISION OF CONTRACTUAL PERFORMANCE BY INCORPORATING AT LEAST BOTH OF THE FOLLOWING:

1. MONITORING AND, AS APPROPRIATE, CONDUCTING AUDITS TO ENSURE THAT THE CONTRACTED FUNCTION IS PROPERLY PERFORMED.

2. ANNUALLY OBTAINING A CERTIFICATION FROM A SENIOR MANAGER WHO HAS RESPONSIBILITY FOR THE CONTRACTED FUNCTION THAT THE MANAGER HAS A REASONABLE BASIS TO REPRESENT, AND DOES REPRESENT, THAT THE FUNCTION IS PROPERLY PERFORMED.

M. AN INSURER IS NOT REQUIRED TO INCLUDE IN ITS SYSTEM OF SUPERVISION:

1. A PRODUCER'S RECOMMENDATIONS TO CONSUMERS OF PRODUCTS OTHER THAN THE ANNUITIES OFFERED BY THE INSURER.

2. CONSIDERATION OF OR COMPARISON TO OPTIONS AVAILABLE TO THE PRODUCER OR COMPENSATION RELATING TO THOSE OPTIONS OTHER THAN ANNUITIES OR OTHER PRODUCTS OFFERED BY THE INSURER.

N. A PRODUCER OR AN INSURER MAY NOT DISSUADE, OR ATTEMPT TO DISSUADE, A CONSUMER FROM:

1. TRUTHFULLY RESPONDING TO AN INSURER'S REQUEST FOR CONFIRMATION OF THE CONSUMER PROFILE INFORMATION.

1 2. FILING A COMPLAINT.
2 3. COOPERATING WITH THE INVESTIGATION OF A COMPLAINT.
3 O. RECOMMENDATIONS AND SALES OF ANNUITIES THAT COMPLY WITH
4 COMPARABLE STANDARDS SATISFY THE REQUIREMENTS UNDER THIS ARTICLE. THIS
5 SUBSECTION APPLIES TO ALL RECOMMENDATIONS AND SALES OF ANNUITIES MADE BY
6 FINANCIAL PROFESSIONALS IN COMPLIANCE WITH BUSINESS RULES, CONTROLS AND
7 PROCEDURES THAT SATISFY A COMPARABLE STANDARD EVEN IF SUCH A STANDARD
8 WOULD NOT OTHERWISE APPLY TO THE PRODUCT OR RECOMMENDATION AT ISSUE. THIS
9 SUBSECTION DOES NOT LIMIT THE DIRECTOR'S ABILITY TO INVESTIGATE AND
10 ENFORCE THIS ARTICLE OR LIMIT THE INSURER'S OBLIGATION TO COMPLY WITH THIS
11 SUBSECTION, ALTHOUGH THE INSURER MAY BASE ITS ANALYSIS ON INFORMATION
12 RECEIVED FROM EITHER THE FINANCIAL PROFESSIONAL OR THE ENTITY SUPERVISING
13 THE FINANCIAL PROFESSIONAL. AN INSURER COMPLIES WITH THIS SUBSECTION IF
14 THE INSURER DOES ALL OF THE FOLLOWING:
15 1. MONITORS THE RELEVANT CONDUCT OF THE FINANCIAL PROFESSIONAL
16 SEEKING TO RELY ON THIS SUBSECTION OR THE ENTITY RESPONSIBLE FOR
17 SUPERVISING THE FINANCIAL PROFESSIONAL, SUCH AS THE FINANCIAL
18 PROFESSIONAL'S BROKER-DEALER OR AN INVESTMENT ADVISER REGISTERED UNDER
19 FEDERAL OR STATE SECURITIES LAWS USING INFORMATION COLLECTED IN THE NORMAL
20 COURSE OF AN INSURER'S BUSINESS.
21 2. PROVIDES TO THE ENTITY RESPONSIBLE FOR SUPERVISING THE FINANCIAL
22 PROFESSIONAL SEEKING TO RELY ON THIS SUBSECTION, SUCH AS THE FINANCIAL
23 PROFESSIONAL'S BROKER-DEALER OR INVESTMENT ADVISER REGISTERED UNDER
24 FEDERAL OR STATE SECURITIES LAWS, INFORMATION AND REPORTS THAT ARE
25 REASONABLY APPROPRIATE TO ASSIST THE ENTITY TO MAINTAIN ITS SUPERVISION
26 SYSTEM.
27 P. FOR THE PURPOSES OF THIS SECTION:
28 1. "COMPARABLE STANDARDS" MEANS:
29 (a) WITH RESPECT TO BROKER-DEALERS AND REGISTERED REPRESENTATIVES
30 OF BROKER-DEALERS, APPLICABLE SEC AND FINRA RULES RELATING TO BEST
31 INTEREST OBLIGATIONS AND SUPERVISION OF ANNUITY RECOMMENDATIONS AND SALES,
32 INCLUDING REGULATION BEST INTEREST AND ANY AMENDMENTS OR SUCCESSOR
33 REGULATIONS.
34 (b) WITH RESPECT TO INVESTMENT ADVISERS REGISTERED UNDER FEDERAL OR
35 STATE SECURITIES LAW OR INVESTMENT ADVISER REPRESENTATIVES, THE FIDUCIARY
36 DUTIES AND ALL OTHER REQUIREMENTS IMPOSED ON THE INVESTMENT ADVISERS OR
37 INVESTMENT ADVISER REPRESENTATIVES BY CONTRACT OR UNDER THE INVESTMENT
38 ADVISERS ACT OF 1940, INCLUDING THE FORM ADV AND INTERPRETATIONS.
39 (c) WITH RESPECT TO PLAN FIDUCIARIES OR OTHER FIDUCIARIES, THE
40 FIDUCIARY DUTIES AND ALL OTHER REQUIREMENTS ATTENDANT TO SUCH A STATUS
41 UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974 OR THE INTERNAL
42 REVENUE CODE AND ANY AMENDMENTS OR SUCCESSOR STATUTES.
43 2. "FINANCIAL PROFESSIONAL" MEANS A PRODUCER THAT IS REGULATED AND
44 ACTING AS:

(a) A BROKER-DEALER REGISTERED UNDER FEDERAL OR STATE SECURITIES LAWS OR A REGISTERED REPRESENTATIVE OF A BROKER-DEALER.

(b) AN INVESTMENT ADVISER REGISTERED UNDER FEDERAL OR STATE SECURITIES LAWS OR AN INVESTMENT ADVISER REPRESENTATIVE ASSOCIATED WITH THE FEDERAL OR STATE INVESTMENT ADVISER.

(c) A PLAN FIDUCIARY UNDER SECTION 3(21) OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974 OR SECTION 4975(e)(3) OF THE INTERNAL REVENUE CODE.

Sec. 5. Section 20-1243.05, Arizona Revised Statutes, is amended to read:

20-1243.05. Compliance; enforcement; penalties

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 PRODUCER, the director may order:

1. ~~An~~ THE insurer to take reasonably appropriate corrective action for any consumer who is harmed by ~~the insurer's or by the insurer's insurance producer's violation of this article~~ A FAILURE TO COMPLY WITH THIS ARTICLE BY THE INSURER, AN ENTITY CONTRACTED TO PERFORM THE INSURER'S SUPERVISORY DUTIES OR THE PRODUCER.

2. ~~An insurance~~ A GENERAL AGENCY, INDEPENDENT AGENCY OR THE producer to take reasonably appropriate corrective action for any consumer who is harmed by ~~an insurance~~ THE producer's violation of this article.

~~3. A business entity that employs or contracts with an insurance producer to sell, or solicit the sale of, annuities to consumers to take reasonably appropriate corrective action for any consumer who is harmed by the insurance producer's violation of this article.~~

3. APPROPRIATE PENALTIES AND SANCTIONS.

B. The director may reduce or eliminate any applicable penalty under sections 20-220, 20-295 and 20-456 for a violation of ~~section 20-1243.03, subsection A, B or D~~ THIS ARTICLE if corrective action for the consumer was taken promptly after a violation was discovered.

C. THE AUTHORITY TO ENFORCE COMPLIANCE WITH ARTICLE IS VESTED EXCLUSIVELY WITH THE DIRECTOR.

Sec. 6. Section 20-1243.06, Arizona Revised Statutes, is amended to read:

20-1243.06. Recordkeeping

A. Insurers, managing general agents, business entities and ~~insurance~~ producers shall maintain, or be able to make available to the director, records of the information collected from the consumer, DISCLOSURES MADE TO THE CONSUMER, INCLUDING SUMMARIES OF ORAL DISCLOSURES, and other information used in making the recommendations that were the basis for insurance transactions for at least five years or until the next regular examination by the insurance regulatory authority of its state of domicile, whichever is later, after the insurance transaction is completed

by the insurer. An insurer may BUT IS NOT REQUIRED TO maintain documentation on behalf of ~~an insurance~~ A producer.

B. Records required to be maintained by this article may be maintained in paper, photographic, microprocess, magnetic, mechanical or electronic media or by any process that accurately reproduces the actual document.

Sec. 7. Section 20-1243.07, Arizona Revised Statutes, is amended to read:

20-1243.07. Producer training; annuities; continuing education

A. ~~An insurance~~ A producer may 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. ~~An insurance~~ A producer may rely on insurer-provided product-specific training standards and materials to comply with this subsection.

B. Before selling, soliciting or negotiating an annuity, ~~an insurance~~ A producer with a life insurance line of authority shall complete a onetime four credit-hour training course approved pursuant to section 20-2904 that is provided by an education provider approved pursuant to section 20-2904.

C. The minimum length of the training required under subsection B of this section shall be sufficient to qualify for at least four continuing education credit hours, but may be longer. The training required under subsection B of this section shall include information on the following topics:

1. Types of annuities and various classifications of annuities.

2. Identification of the parties to an annuity.

3. How product-specific annuity contract features affect consumers.

4. The application of income taxation of qualified and nonqualified annuities.

5. The primary uses of annuities.

6. Appropriate STANDARD OF CONDUCT, sales practices, replacement requirements and disclosure requirements.

D. A provider of an annuity training course intended to comply with this section shall cover all topics listed in subsection C of this section and may not present any marketing information, provide training on sales techniques or provide specific information about a particular insurer's products. Additional topics may be offered in conjunction with and in addition to the topics listed in subsection C of this section. A provider of an annuity training course intended to comply with this section shall register as a continuing education provider in this state and shall comply with the rules and guidelines applicable to ~~insurance~~ producer continuing education courses required by chapter 18 of this title. A provider of an annuity training course shall comply with the reporting requirements and

1 shall issue a certificate of completion in accordance with chapter 18 of
2 this title.
3 E. Annuity training courses may be conducted and completed by
4 classroom or self-study methods in accordance with chapter 18 of this
5 title and any rules of the department. Satisfactory completion of the
6 training requirements of another state that are substantially similar to
7 the provisions of this section satisfy the training requirements of this
8 section. SATISFACTORY COMPLETION OF THE COMPONENTS OF THE TRAINING
9 REQUIREMENTS OF ANY COURSE OR COURSES WITH COMPONENTS THAT ARE
10 SUBSTANTIALLY SIMILAR TO THE REQUIREMENTS PRESCRIBED IN THIS SECTION
11 SATISFY THE TRAINING REQUIREMENTS OF THIS SECTION.
12 F. An insurer shall verify that ~~an insurance~~ A producer has
13 completed the annuity training course REQUIRED UNDER THIS SECTION before
14 allowing the producer to sell an annuity product for that insurer. An
15 insurer may satisfy its responsibility under this subsection by obtaining
16 certificates of completion of the annuity training course or obtaining
17 reports provided by department-sponsored database systems or vendors or
18 from a reasonably reliable commercial database vendor that has a reporting
19 arrangement with approved insurance education providers.
20 Sec. 8. Insurance producers; annuity training courses;
21 requirements; delayed repeal
22 A. An insurance producer who, before the effective date of this
23 act, has completed an annuity training course pursuant to section
24 20-1243.07, Arizona Revised Statutes, as amended by this act within six
25 months after the effective date of this act shall complete either:
26 1. A new four credit hour annuity training course approved by the
27 director of the department of insurance and financial institutions after
28 the effective date of this act.
29 2. An additional onetime one credit hour annuity training course,
30 approved by the department of insurance and financial institutions and
31 provided by an education provider approved by the department, on
32 appropriate sales practices, replacement and disclosure requirements
33 prescribed in title 20, chapter 6, article 1.3, Arizona Revised Statutes,
34 as amended by this act
35 B. This section is repealed from after December 31, 2021.

Regulatory Notice 20-16

May 28, 2020

Transition to Remote Work and Remote Supervision

FINRA Shares Practices Implemented by Firms to Transition to, and Supervise in, a Remote Work Environment During the COVID-19 Pandemic

Summary

The COVID-19 pandemic significantly affected firms' day-to-day operations across the securities industry, including requiring firms to transition most or all their staff to remote work environments and implement remote supervisory practices. FINRA is committed to providing guidance, updates and other information to help firms and stakeholders stay informed about the latest regulatory developments relating to COVID-19, which can be found on FINRA's COVID-19/Coronavirus Topic Page, as well as in recent *Notices* issued to address COVID-19-related fraud, cybersecurity threats and other emerging issues.

As part of that effort, we prepared this *Notice* to share common themes FINRA observed through discussions with small, mid-size and large firms about the steps they reported taking to transition their associated persons and supervisory procedures to a remote work environment. This *Notice* does not represent a comprehensive inventory of all possible approaches taken by firms, nor does it include exam findings or effective practices because we have not evaluated these practices in our examination program.

Firms may wish to consider whether the practices described below are applicable to their own circumstances and would enhance their supervisory systems and compliance programs.[1] FINRA reminds firms that they must continue to implement a reasonably designed supervisory system appropriately designed for their size and business model. In addition, firms must memorialize in writing any adjustments made to their policies and supervisory procedures as a result of the COVID-19 pandemic.

We encourage firms to contact their designated Risk Monitoring Analyst if they have questions about the practices described in this report, or to discuss any challenges they encounter as a result of the pandemic.

Notice Type

- Special Alert

Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management

Key Topics

- Business Continuity Planning
- Supervision
- Communications with Customers

Referenced Rules & Notices

- FINRA Rule 3110
- FINRA Rule 4370
- Regulatory Notice 13-25
- Regulatory Notice 20-08

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Background and Discussion

I. Transitioning to a Remote Work Environment

Firms discussed the challenges they faced when transitioning to remote work environments, implementing their business continuity plans (BCPs), closing branches and offices and supporting customers with these changes. In particular, certain firms that relied on web-based tools, electronic document management systems and cloud-based services, and regularly tested their remote connectivity, capacity, work processes and trading capabilities believed they faced fewer difficulties transitioning to a remote work and supervisory environment. Further, some firms that had been making continuous updates to their BCPs[2] and maintained hot (fully live and connected) disaster recovery sites also concluded that they experienced a smoother transition.

In addition, some firms noted the following additional efforts relating to physical office space and remote work:

- **Customer Assistance**—Helped customers navigate branch and office closures by providing back-up contact information for the firm, branches and associated persons on firms' websites[3] and to representatives at their call centers and by redirecting phone lines and voicemails to a centralized group. In addition, back-up branch office partner programs were established where calls to a closed branch office were forwarded to an open branch office and in-office appointments were handled by a centralized group.
- **Move to Remote Work**—Implemented certain remote work protocols to facilitate the transition:
  - **Location Monitoring**—Asking remote staff to report their location to their managers, requiring approval before making changes to their location and keeping a record of the locations of all remote staff; and
  - **Contact Lists**—Providing staff with updated contact information for their assigned points of contact in Compliance, Legal, Operations and other departments.
- **Additional Support and Communication to Staff**—Provided the following additional information and tools to associated persons and other staff to facilitate working remotely and to minimize the risk they would use personal or unapproved systems and technology to conduct firm business:
  - holding firmwide "all hands" calls and videoconferences for all staff so that firm leadership could provide updates on firm operations;
  - communicating clear guidance about firm expectations while working from home;
  - transitioning to virtual training to continue preparing for upcoming regulatory obligations, such as Regulation Best Interest;
  - providing additional technology tools, such as internet boosters, VPN hotspots, remote devices and laptops to better equip staff to work from home;

- making available new digital collaboration platforms and applications; and
- disseminating additional guidance and training regarding use of firm technology, tools and services in a remote work environment.

- **Increased Focus on Confidentiality and Cybersecurity**—Emphasized the importance of, and provided additional guidance on, obligations that are especially important in a remote work environment, such as:
  - **Confidentiality of Firm and Customer Information**—Using notices and training to remind associated persons about their confidentiality obligations with respect to retail and other customers' information, including complying with material non-public information requirements; maintaining a private workspace while working from home; and taking extra precautions when working near family members or roommates. If applicable, certain firms also noted that staff should consider whether the employment of family members or roommates working from home may raise a conflict of interest that needs to be reported to the firm.
  - **Cybersecurity and Fraud**—Reminding and training staff about increased cybersecurity vulnerabilities and potential fraud risks in a remote work environment. Certain firms also engaged in additional efforts to monitor and assess critical information technology vendors by, for example, engaging a third-party oversight team.

II. Supervision in a Remote Work Environment

Firms generally acknowledged the challenges relating to remote supervision, but also reported that they were relatively prepared to remotely supervise their associated persons using existing methods of supervision, such as supervisory checklists, surveillance tools, incident trackers, email review and trade exception reports. In particular, certain firms that already maintained comprehensive remote supervision capabilities reported they easily transitioned to supervising their associated persons in the new remote work environment.

Some firms also took the following steps to address the additional concerns relating to remote supervision:

a. General Supervision

- **Testing**—Prepared to meet their supervisory obligations in a remote work environment by conducting additional testing of their remote supervision capabilities, in some cases, weeks ahead of when state or local shelter-at-home orders went into effect and performing a gap analysis between normal and remote supervision documentation requirements.
- **Additional Support and Communications to Supervisors**—Provided additional guidance and resources to supervisors by:
  - underscoring the increased importance of supervision in a remote work environment and coaching their supervisors—and their staff—to "over-escalate" potential issues and concerns;

- scheduling daily or weekly meetings for all senior leadership and supervisors to provide regular updates, which included emerging issues relating to remote work;
- creating regular meetings and, in certain situations, continuously open chat rooms or teleconference lines, for supervisors to discuss concerns and raise questions with compliance staff;
- sending reminders to supervisors about ongoing regulatory responsibilities and applicable firm policies that are especially important in a remote work environment (such as confidentiality and cybersecurity, which are described in more detail above); and
- creating new electronic supervisory checklists with attestations and electronic affirmation via voting buttons.

- ► **Analysis of Emerging Risks**—Engaged in analysis of areas where firms received increased alerts, exception reports and customer complaints to identify potential emerging issues or trends that needed to be addressed.
- ► **Feedback**—Requested real-time feedback from staff and conducted weekly assessments on remote work and supervision arrangements to determine effective practices and shared lessons learned across the firm.

b. Trading Supervision

Some firms reported that their existing trading systems allowed them to successfully perform remote supervision, compliance monitoring and surveillance. Where necessary, however, firms also implemented new trading tools that replicated or directly accessed traders' office trading systems from the traders' homes and provided supervisors with comprehensive remote supervision capabilities.

Some firms enhanced their oversight of trading activity through a number of measures:

- ► **Remote Trading Prescreen and Supervisory Processes**—Implemented screening processes and additional supervisory requirements before permitting anyone to engage in remote trading, and additional supervisory requirements, which included:
  - requiring traders to complete attestations stating that they understand and will comply with relevant policies and procedures, focusing on critical compliance topics relating to remote work, such as information barriers, voice recordings, mobile devices, privacy and recordkeeping requirements;
  - implementing a process for senior management to approve each trader to work remotely;
  - testing the trader's remote trading capabilities with an assigned in-office partner;

  - having senior management review the test results, including details about the test trades, traders' work location, pre- and post-trade risk, latency and overall test experience;
  - submitting to firm leadership a formal memo describing the remote work arrangement with traders' information (including remote location and planned trading activities) and feedback from the pilot review;
  - requiring all supervisors responsible for monitoring remote traders to complete a special supervisory checklist; and
  - maintaining and updating daily a contact list of all remote traders for senior management.

- **Trade Reports and Alerts**—Increased the frequency of their review, changed the existing thresholds relating to certain trade reports and alerts to increase the scope of their surveillance, or created additional alerts requiring traders to provide their rationale for certain activities.
- **Communication Tools**—Used new communication tools in an attempt to replicate traditional "line of sight" supervision in a remote work environment, such as keeping cameras, chat rooms, other collaboration tools and conference calls on during the day and scheduling daily rollcalls and multiple check-ins per day.
- **Additional Monitoring**—Implemented additional central monitoring and reviews of all supervisory activities, such as task and alert intake volumes and completion rates.

c. Supervision of Communication With Customers

Some firms reported that they relied on existing methods to supervise associated persons' communications with customers, but acknowledged the additional risks of remote work environments and took extra measures to reinforce that associated persons must use only firm-provided and approved communication systems and tools, such as firm email, messaging platforms and softphones with recording capabilities (for staff requiring voice recording).

In addition, certain firms engaged in extra efforts relating to supervision of associated persons' customer communications, including:

- **Email Review**—Increased the volume and frequency of supervisory review of email communications.
- **Key Word Surveillance**—Implemented additional key word search functionalities for their communication surveillance to identify potential communication outside of approved firm systems and tools.

- **Recorded Lines**—Required all traders to use recorded lines for all conversations relating to transmission of orders, and, in some cases, required staff who were not previously subject to the firm's voice recording requirements to use phone applications that recorded their conversations.
- **Chat Restrictions**—Disabled certain features and functionalities of video conferencing platforms, such as chat, that would be subject to recordkeeping obligations that the firms could not fulfill in the remote work environment.

d. Branch Inspections

Firms reported that they adjusted their branch inspection programs to accommodate remote work requirements and travel restrictions. Many firms stopped conducting on-site inspections and, instead, created and implemented a temporary, fully remote inspection plan using video conferencing, electronic document review and other technological tools. Depending on the duration and severity of the stay-at-home orders and travel restrictions, firms were planning to complete the onsite portions of the inspections in the future, and, for high risk branches, to prioritize those inspections.

Endnotes

1. This *Notice* is not intended to create new obligations, nor does it relieve firms of any existing obligations under federal securities laws and regulations.
2. *See* FINRA Rule 4370(b) (Business Continuity Plans and Emergency Contact Information) (requiring firms to update their plans "in the event of any material change to" [their] operations, structure, business or location] and conduct an annual review of their BCP to "determine whether any modifications are necessary in light of changes to [their] operations, structure, business, or location)"; *Regulatory Notice 13-25* (FINRA, the SEC and CFTC Issue Joint Advisory on Business Continuity Planning) (noting that "remote access is an important component of business continuity planning" and firms should "consider their employees' ability to work from home," including "identifying technology and communications products and services that could increase efficiency" and focusing on "key control functions such as compliance, risk management, back office operations and financial and regulatory reporting").
3. *See* *Regulatory Notice 20-08* (Pandemic-Related Business Continuity Planning, Guidance and Regulatory Relief) (noting that, "[i]f registered representatives are unavailable to service their customers, member firms are encouraged to promptly place a notice on their websites indicating to affected customers who they may contact concerning the execution of trades, their accounts, and access to funds or securities.").

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FINRA

Artificial Intelligence (AI) in the Securities Industry[1]

JUNE 2020

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A REPORT FROM **THE FINANCIAL INDUSTRY REGULATORY AUTHORITY**

Introduction

Artificial Intelligence (AI) technology is transforming the financial services industry across the globe. Financial institutions are allocating significant resources to exploring, developing, and deploying AI-based applications to offer innovative new products, increase revenues, cut costs, and improve customer service.[2] First developed in the early 1940s, AI technology has gained significant momentum over the past decade and become more mainstream due in part to the availability of inexpensive computing power, large datasets, cloud storage, and sophisticated open-source algorithms. In a recent survey-based report, executives at financial institutions noted that "AI is expected to turn into an essential business driver across the Financial Services industry in the short run, with 77% of all respondents anticipating AI to possess high or very high overall importance to their businesses within two years."[3]

Broker-dealers are exploring and deploying AI-based applications across different functions of their organizations, including customer facing, investment, and operational activities. In July 2018, FINRA solicited comments from the industry on the potential challenges associated with using and supervising AI applications at broker-dealer firms.[4] In response, commenters recommended that FINRA undertake a broad review of the use of AI in the securities industry to better understand the varied applications of the technology, their associated challenges, and the measures taken by broker-dealers to address those challenges. Based on this feedback, FINRA, through its Office of Financial Innovation (OFI), engaged in an active dialogue with the industry over the past year and held meetings with over two dozen market participants, including broker-dealer firms, academics, technology vendors, and service providers to learn more about the use of AI in the securities industry.

[1] This paper is not intended to express any legal position and does not create any new requirements or suggest any change in any existing regulatory obligations, nor does it provide relief from any regulatory obligations. While this paper summarizes key findings from FINRA's outreach and research on the use of AI applications in the securities industry, it does not endorse or validate the use or effectiveness of any of these applications. Further, while the paper highlights certain regulatory and implementation areas that broker-dealers may wish to consider as they adopt AI, the paper does not cover all applicable regulatory requirements or considerations. FINRA encourages firms to conduct a comprehensive review of all applicable securities laws, rules, and regulations to determine potential implications of implementing AI-based applications.

[2] PwC, Crossing the Lines: How Fintech is Propelling FS and TMT Firms Out of Their Lanes, 2019, PDF (reporting that financial services executives expect their AI efforts to result in increased revenue and profits (50%), better customer experiences (48%), and innovative new products (42%).).

[3] Ryll et al., Transforming Paradigms: A Global AI in Financial Services Survey, Jan. 2020, PDF.

[4] FINRA, Special Notice on Financial Technology Innovation in the Broker-Dealer Industry, July 30, 2018, Article.

This paper summarizes key findings from FINRA's review in three sections:

- Section I briefly defines AI and its scope as it pertains to the securities industry for the purposes of this paper.
- Section II provides an overview of broker-dealers' use of AI applications related to: (i) communications with customers, (ii) investment processes, and (iii) operational functions.
- Finally, Section III discusses key factors including potential regulatory considerations, securities market participants may want to consider as they develop and adopt AI-based tools.

The discussion below is intended to be an initial contribution to an ongoing dialogue with market participants about the use of AI in the securities industry. Accordingly, FINRA requests comments on all areas covered by this paper.[5] FINRA also requests comments on any matters for which it would be appropriate to consider guidance, consistent with the principles of investor protection and market integrity, related to AI applications and their implications for FINRA rules.

I. Overview of Artificial Intelligence Technology

Definition

The term artificial intelligence broadly refers to applications of technology to perform tasks that resemble human cognitive function and is generally defined as "[t]he capability of a machine to imitate intelligent human behavior."[6] AI typically involves "[t]he theory and development of computer systems able to perform tasks normally requiring human intelligence, such as visual perception, speech recognition, decision-making, and translation between languages."[7] John McCarthy, one of the founders of AI research, "once defined the field as getting a computer to do things which, when done by people, are said to involve intelligence."[8]

Scope[9]

While the definitions for AI discussed above provide a general outline of the meaning of the term, there is no single universally agreed upon definition of AI. In practice, AI is used as an umbrella term that encompasses a broad spectrum of different technologies and applications, some of which are described below.

- **Machine Learning (ML) –** Machine learning is a field of computer science that uses algorithms to process large amounts of data and learn from it. Unlike traditional rules-based programming, ML models[10] learn from input data to make predictions or identify meaningful patterns without being explicitly programmed to do so. There are different types of ML models, depending on their intended function and structure:

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5 See Request for Comments section on page 20 of this paper.

6 Artificial Intelligence, Merriam Webster, Article.

7 Artificial Intelligence, Oxford English Dictionary, Article.

8 Shukla Shubhendu & Jaiswal Vijay, Applicability of Artificial Intelligence in Different Fields of Life, International Journal of Scientific Engineering and Research, 29–35 (2013), PDF.

9 The definition and scope of AI presented here are intended purely to frame the discussion in this document and should not be interpreted as guidance. In our discussions with industry participants, there is a wide spectrum of viewpoints with no consensus on the definition or scope of the technology.

10 An ML model generally refers to the combination of input data, key features identified from the data, algorithms, parameters, and outputs that are collectively used to build the AI application.

- **Supervised Machine Learning –** In supervised ML, the model is trained with labeled input data that correlates to a specified output. For example, a dataset of animal photos (input data) can be labeled as "cats" or "not cats" (output data). The model is continuously refined to provide more accurate output as additional training data becomes available. After the model has learned from the patterns in the training data, it can then analyze additional data to produce the desired output. Results of supervised ML models are typically reviewed by humans for accuracy and fed back into the model for further refinement. Supervised ML is successful when the model can consistently produce accurate predictions when provided with new datasets. For example, the ML model learns to recognize if a new picture is a cat or not.
- **Unsupervised Machine Learning –** In unsupervised ML, the input data is not labeled nor is the output specified. Instead, the models are fed large amounts of raw data and the algorithms are designed to identify any underlying meaningful patterns. The algorithms may cluster similar data but do so without any preconceived notion of the output. For example, a time series of trade events can be inputted into an unsupervised model, with the model identifying groups of similar trades as well as outliers. Results of unsupervised machine learning models are then interpreted by humans to determine if they are meaningful and relevant.
- **Reinforcement Learning –** In reinforcement learning, the model learns dynamically to achieve the desired output through trial and error. If the model algorithm performs correctly and achieves the intended output, it is rewarded. Conversely, if it does not produce the desired output, it is penalized. Accordingly, the model learns over time to perform in a way that maximizes the net reward. For example, in the securities industry, reinforcement learning models are being explored for options pricing and hedging.[11]
- **Deep Learning –** A deep learning model is built on an artificial neural network, in which algorithms process large amounts of unlabeled or unstructured data through multiple layers of learning in a manner inspired by how neural networks function in the brain. These models are typically used when the underlying data is significantly large in volume, obtained from disparate sources, and may have different formats (*e.g.*, text, voice, and video). For example, some firms in the securities industry are developing surveillance and conduct monitoring tools built on deep learning models. Deep learning applications can be supervised, unsupervised, or reinforcement based.

▶ **Natural Language Processing (NLP) –** NLP is a form of AI that enables machines to read or recognize text and voice, extract value from it, and potentially convert information into a desired output format, such as text or voice. Examples of NLP applications in the securities industry range from keyword extraction from legal documents and language translation to more complex tasks, such as sentiment analysis and providing relevant information through chat-boxes and virtual assistants.

▶ **Computer Vision (CV) –** CV (also referred to as machine vision) is a "field of computer science that works on enabling computers to see, identify and process images in the same way that human vision does, and then provide appropriate output."[12] Frequently a CV application will use ML models to interpret what it "sees" and make predictions or determinations. Examples of CV-based applications include facial recognition, fingerprint recognition, optical character recognition, and other biometric tools to verify user identity.

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[11] Halperin, Igor, QLBS: Q-Learner in the Black-Scholes (-Merton) Worlds, SSRN, Dec. 16, 2017, Article 1 or Article 2.

[12] What is Computer Vision?, Techopedia, Article.

- **Robotics Process Automation (RPA) –** RPA refers to the use of preprogrammed software tools that interact with other applications to automate labor-intensive tasks, resulting in increased accuracy, speed, and cost-savings. RPA tools are generally used for high-volume, repetitive processes involving structured data, such as account reconciliation, accounts payable processing, and depositing of checks. Some market participants do not consider RPA to be a form of AI because its focus is on automation of processes in a manner more akin to a rules-based system.[13] However, others consider it to be a rudimentary form of AI, particularly when it is combined with other technologies such as ML.

Key Components of AI Applications

AI applications generally involve the use of data, algorithms, and human feedback. Ensuring each of these components is appropriately structured and validated is important for the development and implementation of AI applications. The discussion that follows highlights how each of these components influences the development of AI applications.

- **Data –** Data generation in the financial services industry has grown exponentially over the past decade, in part due to the use of mobile technologies and the digitization of data. The importance of data has likewise rapidly increased, and some have even referred to data as a more valuable resource than oil.[14] Furthermore, cloud technology has enabled firms to collect, store, and analyze significantly large datasets at very low costs. Firms in the financial services industry now collect data from a variety of internal sources (*e.g.*, trading desks, customer account history, and communications) and external sources (*e.g.*, public filings, social media platforms, and satellite images) in both structured and unstructured formats, and analyze this data to identify opportunities for revenue generation as well as cost-savings. This explosion of data in the financial services industry is one of the key factors contributing to the increased exploration of AI in the industry.

  Data plays a critical role in the training and success of any AI application. AI applications are generally designed to analyze data by identifying patterns and to make determinations or predictions based on those patterns. The applications continuously and iteratively learn from any inaccurate determinations made by such applications, typically identified through human reviews as well as from new information, and refine the outputs accordingly. Therefore, AI applications are generally best positioned to yield meaningful results when the underlying datasets are substantially large, valid, and current.

- **Algorithms –** An algorithm is a set of well-defined, step-by-step instructions for a machine to solve a specific problem and generate an output using a set of input data. AI algorithms, particularly those used for ML, involve complex mathematical code designed to enable the machines to continuously learn from new input data and develop new or adjusted output based on the learnings. An AI algorithm is "not programmed to perform a task, but is programmed to learn to perform the task."[15] The availability of open-source AI algorithms, including those from some of the largest technology companies, has helped fueled AI innovation and made the technology more accessible to the financial industry.

[13] SIFMA, Re: Special Notice on Financial Technology Innovation in the Broker-Dealer Industry, Oct. 18, 2018, PDF (stating in its comment letter, published on July 30, 2018, that "…innovations such as the majority of robotic process automation ("RPA") do not use AI, but nevertheless equally deserve to be considered with regards to matters of supervision."). FINRA does not take an explicit view on the status of RPA in the context of AI, but for purposes of this report the use of the term AI does not encompass applications involving basic RPA.

[14] The World's Most Valuable Resource is no Longer Oil, but Data, The Economist, May 6, 2017, Article.

[15] Alexandre Gonfalonieri, What is an AI Algorithm?, Medium, Apr. 21, 2019, Article.

- **Human interaction –** Human involvement is imperative throughout the life cycle of any AI application, from preparing the data and the algorithms to testing the output, retraining the model, and verifying results. As data is collected and prepared, human reviews are essential to curate the data as appropriate for the application. As algorithms sift through data and generate output (*e.g.*, classifications, outliers, and predictions), the next critical component is human review of the output for relevancy, accuracy, and usefulness. Business and technology stakeholders typically work together to analyze AI-based output and give appropriate feedback to the AI systems for refinement of the model. Absence of such human review and feedback may lead to irrelevant, incorrect, or inappropriate results from the AI systems, potentially creating inefficiencies, foregone opportunities, or new risks if actions are taken based on faulty results.

II. AI Applications in the Securities Industry

The use of AI-based applications is proliferating in the securities industry and transforming various functions within broker-dealers. Some large firms have established centers of excellence to review, share, and build expertise and create synergies related to the use of AI across their organizations. In addition, firms are exploring and incorporating AI tools built by financial technology startups and vendors.

In this section, we highlight three broad areas where broker-dealers are evaluating or using AI in the securities industry: communications with customers, investment processes, and operational functions. Specifically, with respect to communications with customers, the discussion explores how firms are using AI to enhance customer experience and outreach targeting. With respect to investment processes, the discussion explores how firms are using AI to assist with brokerage account management, portfolio management, and trading. Finally, with respect to operational functions, the discussion explores how firms are using AI to assist with compliance, risk management, and administrative tasks.

While this section of the paper provides a high-level informational summary of key AI applications that securities industry participants shared with FINRA staff, it is neither an exhaustive list of possible applications nor intended to be an endorsement of any particular use case. Although the use cases noted below may offer several potential benefits, they also involve potential challenges, costs, and regulatory implications. Each firm should conduct its own due diligence and legal analysis when exploring any AI application to determine its utility, impact on regulatory obligations, and potential risks, and set up appropriate measures to mitigate those risks. Furthermore, use of AI applications does not relieve firms of their obligations to comply with all applicable securities laws, rules, and regulations.

Communications with Customers

Customer Experience

The use of AI in applications to enhance customer experience has gained significant traction, not just in the securities industry but broadly within the financial services industry. AI-based customer service applications largely involve NLP- and ML-based tools that automate and customize customer communications.

- **Virtual assistants –** A virtual assistant is an AI application that interacts with humans using voice recognition and synthesized speech and is programmed to perform certain tasks. Several firms have already deployed, or are in the process of deploying, virtual assistants to provide digital customer service. Firms have noted that their virtual assistants provide responses to basic customer inquiries, such as those related to account balances, portfolio holdings, market data, address changes, and password resets. At a few firms, virtual assistants also offer the ability to accept and process trade orders within certain thresholds.

  Firms are deploying virtual assistants through different platforms. Several online firms have deployed conversational chatbots through their websites and mobile apps.[16] Some firms noted that they are experimenting with the development of virtual assistant applications available to customers through third-party platforms, such as Amazon's Alexa, Google's Home Assistant, and Apple's Siri. In addition, some firms are integrating AI-based interactive voice response (IVR) systems at their call centers to respond to basic inquiries from callers or collect sufficient information to facilitate triaging of calls to the appropriate human customer service agents.

  These online, device-based, and telephonic virtual assistants employ NLP (including speech-to-text/text-to-speech conversion, tone recognition, and text generation), ML, and sophisticated customer authentication tools, including the use of facial recognition, fingerprints, and voice biometrics. The applications are trained with large sets of historical and current data, including customer account information, trading history, and past inquiries, as well as market data, to formulate appropriate responses to incoming customer inquiries.

- **Email inquiries –** Some firms indicated that they are using AI-based applications to screen and classify incoming client emails based on key features, such as the sender's identity, the email's subject line, and an automated review of the email message itself. Such applications may also automatically respond to emails containing common or routine inquiries, while routing emails with complex inquiries to the appropriate personnel. Firms also noted using similar applications to process and triage internal inquiries (*e.g.*, those received by internal help desks), to provide automated responses where possible, and to route more complicated inquiries to relevant subject matter experts.

Outreach Targeting

A number of broker-dealers are exploring the use of AI to target outreach to customers or potential customers. Some firms are using AI tools to analyze their customers' investing behaviors, website and mobile app footprints, and past inquiries, and in turn, to proactively provide customized content to them. This could include curated educational information, news, and research reports on specific investment products or asset classes. This content could be delivered to customers by email or directly through the firm's website or mobile app. In addition, firms have also indicated AI tools are being explored to determine whether individuals would be interested in certain services based on their customer profile and browsing history within the firms' websites.

Industry participants noted that the exploration and deployment of AI-based applications for customer communications, particularly automated virtual assistants, have gained significant traction because they may help to enhance customer experience, create significant internal cost efficiencies for firms, and provide opportunities for greater engagement between the firm and customer. However, these applications may also pose certain challenges and potential risks, such as those associated with customer authentication, data privacy, cybersecurity, and recordkeeping.

[16] A chatbot is a computer program or a software that simulates conversations with humans in the form of text or voice messages.

Investment Processes

Brokerage Account Management

Brokerage account management functions at some large firms are starting to incorporate AI-based tools to provide individual brokers with customized, real-time customer information and better insights into customer preferences and trading behaviors. Registered representatives use such information to enhance customer relationships, to provide better service and recommendations, and to potentially minimize customer attrition. The following are some examples shared by firms for the use of AI in understanding customer needs and managing their brokerage accounts:

- **Holistic customer profiles –** Firms are starting to develop AI-based applications that create real-time, holistic customer profiles, which incorporate information from a broad range of sources, such as customer assets (held both at the firm and outside the firm), spending patterns, and debt balances obtained through data aggregation tools; updates on social media and other public websites; browsing history on the firm's website and mobile apps; and past communications (*e.g.*, from emails, chat messages, and meeting notes). All this information is analyzed using AI tools to provide the registered representative with a broader picture of customer needs, along with tailored suggestions of what investment products the customer may be interested in. Industry participants indicated that registered representatives use this information to augment their existing knowledge and expertise when making suggestions to their customers. Industry participants noted taking a cautious approach to employing AI tools that may offer investment advice and recommendations directly to retail customers, citing several legal, regulatory, and reputational concerns.[17]
- **Customized research –** Firms have also indicated growing use of AI tools to provide curated market research directly to customers to share relevant information on various investment opportunities. For example, as noted in the earlier section, AI-based tools may offer customers social media data and related sentiment analysis on investment products and asset classes.

While these AI tools offer the potential to customize investment suggestions for customers, firms should be cognizant of potential concerns and challenges related to data privacy, use of corrupt or misleading data, and adapting to each customer's unique circumstances.[18]

Portfolio Management and Trading

Broker-dealers are also exploring and using AI applications within their portfolio management and trading functions.

- **Portfolio management –** Within portfolio management, firms noted the use of AI applications to identify new patterns and predict potential price movements of specific products or asset classes. These applications tap into vast amounts of data available from internal and external sources, including from non-traditional sources like social media and satellite imagery, which is used as proxy data for economic activity to identify insights that may signal price movement. Some broker-dealers that are also investment advisors aim to incorporate these predictions into their investment strategies to generate alpha for the portfolio.

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[17] In the U.S., digital investment platforms (commonly referred to as "robo-advisors") that offer investment advice directly to clients via online platforms, currently largely use rules-based models to develop those recommendations. See FINRA, Report on Digital Investment Advice, Mar. 2016, PDF.

Firms may wish to review their AI-based investment tools to determine whether related activity may be deemed as offering discretionary investment advice and therefore implicate the Investment Advisors Act of 1940.

[18] FINRA, Social Sentiment Investing Tools – Thing Twice Before Trading Based on Social Media, Apr. 2019, Article.

- **Trading –** Securities industry participants are also exploring AI tools to make their trading functions more efficient by maximizing speed and price performance. Examples include using ML for smart order routing, price optimization, best execution, and optimal allocations of block trades.

Firms should bear in mind that use of AI in portfolio management and trading functions may also pose some unique challenges, particularly where the trading and execution applications are designed to act autonomously. Circumstances not captured in model training – such as unusual market volatility, natural disasters, pandemics, or geopolitical changes – may create a situation where the AI model no longer produces reliable predictions, and this could trigger undesired trading behavior resulting in negative consequences. In addition, some industry participants have expressed concern that AI trading models across the industry may start to learn from each other, potentially leading to collusive activity, herd behavior, or unpredictable results.[19]

Operational Functions

Compliance and Risk Management

In conversations with FINRA staff, industry participants noted that they are spending significant time and resources in developing AI-based applications to enhance their compliance and risk management functions. This is consistent with FINRA's 2018 research on the use of regulatory technology (RegTech), where we observed that "market participants are increasingly looking to use RegTech tools to help them develop more effective, efficient, and risk-based compliance programs."[20] According to an April 2018 research study conducted by Chartis Research and IBM, which surveyed more than 100 relevant risk and technology professionals, 70% of respondents noted using AI in risk and compliance functions.[21]

Broker-dealers have to keep pace with complex and evolving domestic and international regulations, as well as a rapidly changing risk landscape (*e.g.*, cybersecurity, internal threats, and financial risks). At the same time, they now have access to vast amounts of data, inexpensive computing power, and innovative technologies that present opportunities for them to develop automated compliance and risk-management tools. Below are some examples that firms shared of how they are incorporating AI in their compliance and risk management tools.[22]

- **Surveillance and monitoring –** AI technology offers firms the ability to capture and surveil large amounts of structured and unstructured data in various forms (*e.g.*, text, speech, voice, image, and video) from both internal and external sources in order to identify patterns and anomalies. This enables firms to holistically surveil and monitor various functions across the enterprise, as well as monitor conduct across various individuals (*e.g.*, traders, registered representatives, employees, and customers), in a more efficient, effective, and risk-based manner. Market participants noted that these tools could significantly reduce the number of false positives, which in turn, free up compliance and supervisory staff time to conduct more thorough reviews of the remaining alerts, resulting in higher escalation rates. Firms indicate that these tools offer the ability to move beyond "traditional rule-based systems to a predictive, risk-based surveillance model that identifies and exploits patterns in data to inform decision-making."[23] For example, some firms noted the use of AI-based surveillance tools to monitor

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[19] R. Jesse McWaters & Matthew Blake, Navigating Uncharted Waters: A Roadmap to Responsible Innovation with AI in Financial Services, World Economic Forum, Oct. 23, 2019, Article.

[20] FINRA, Technology Based Innovations for Regulatory Compliance ("RegTech") in the Securities Industry, Sept. 2018, PDF [hereinafter FINRA RegTech White Paper].

[21] IBM and Chartis Research, AI in RegTech: A Quiet Upheaval, 2018, Article.

[22] Please note that FINRA does not endorse or validate the use or effectiveness of any specific tools in fulfilling compliance obligations. FINRA encourages broker-dealers to conduct a comprehensive assessment of any compliance tools they wish to adopt to determine their benefits, implications and ability to meet their compliance needs.

communications with customers across various channels, such as emails, social media, and text messaging. Firms noted that these tools gave them the ability to move beyond a traditional lexicon-based review to a more risk-based review, such that they could decipher tone, slang, or code words, which may be indicative of potentially risky or non-compliant behavior.

- **Customer identification and financial crime monitoring –** AI-based tools are also being developed for customer identification (also referred to as "know-your-customer" (KYC)) and financial crime monitoring programs, for example, to detect potential money laundering, terrorist financing, bribery, tax evasion, insider trading, market manipulation, and other fraudulent or illegal activities.[24] Market participants noted that many traditional KYC and financial crime monitoring methods are cumbersome and not as effective as desired, often resulting in high rates of false positives. Consequently, firms have started incorporating AI technologies, such as ML, NLP, and biometrics, to make their programs more effective and risk based. Firms indicated that these tools enable them to identify and track customer activity with greater accuracy and efficiency, and to conduct more holistic and detailed analysis of customer transactions.[25]
- **Regulatory intelligence management –** Broker-dealers use a variety of regulatory intelligence management programs and processes to identify, interpret, and comply with new and changing rules and regulations across jurisdictions. While this has traditionally been a manual process, firms are now exploring the use of AI tools to digitize, review, and interpret new and existing regulatory intelligence (including rules, regulations, enforcement actions, and no-action letters) and to incorporate appropriate changes into their compliance programs. Some industry participants noted that automated regulatory intelligence management programs have the potential to increase overall compliance, while reducing both costs and time spent implementing regulatory change. According to a research report that explores the use of AI by financial institutions for risk and compliance functions, "[a]utomating the process of regulatory change management is something of a 'holy grail' in the use of AI."[26] Some regulators are also exploring and adopting the concept of "machine-readable" rulebooks, which could potentially enable firms to automate the process of identifying, categorizing, and mapping the rules to relevant regulatory obligations within their internal workflows.[27]
- **Liquidity and cash management –** In our discussions, some firms noted that they are employing ML applications to optimize their financial liquidity and cash management. Such applications analyze substantial historical data along with current market data to identify trends, note anomalies, and make predictions, for example, related to intra-day liquidity needs, peak liquidity demands, working capital requirements, and securities lending demand.

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[23] FINRA RegTech White Paper.

[24] The Bank Secrecy Act of 1970 (BSA) requires all broker-dealers to, among other things, implement compliance programs to detect and prevent money laundering. In addition, FINRA Rule 3310 (Anti-Money Laundering Compliance Program) requires all broker-dealers to develop and maintain a written AML program to comply with the requirements of the BSA. FINRA Rule 2090 (Know Your Customer (KYC)) requires broker-dealers to "use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer."

[25] In December 2018, Treasury's FinCEN and federal banking agencies issued a joint statement, encouraging "banks and credit unions to take innovative approaches to combating money laundering, terrorist financing, and other illicit financial threats." Financial Crimes Enforcement Network (FinCEN), Joint Statement Encouraging Innovative Industry Approaches to AML Compliance, Dec. 3, 2018, Article.

[26] IBM and Chartis Research, Demystifying Artificial Intelligence in Risk and Compliance, Apr. 2018, PDF.

[27] FINRA, Special Notice on Financial Technology Innovation, July 30, 2019, PDF (seeking comments from the industry on, amongst other things, the development of a taxonomy-based machine readable rulebook.).
U.K. Financial Conduct Authority, Digital Regulatory Reporting, Jan. 11, 2017, PDF (stating that, in 2017, the U.K. Financial Conduct Authority would launch an initiative to make their rulebooks machine-readable).

- **Credit risk management –** Broker-dealer firms are also employing AI-based models to assess creditworthiness of their counterparties, which both speeds up the credit review process and allows the incorporation of non-traditional criteria (*e.g.*, information available through social media). However, some AI-based credit-scoring systems have faced criticism for being opaque and potentially biased and discriminatory. These models not only analyze traditional credit-evaluation criteria, such as current financial standing and historical credit history, but may also identify other demographic factors as deterministic criteria, which could lead to unfair and discriminatory credit scoring based on biases present in the underlying historical data. (Refer to Section III for additional discussion on the topic.)
- **Cybersecurity –** Cybersecurity continues to be a top challenge for the financial services industry. Perpetrators are continuously evolving and using sophisticated technology, including AI, to conduct their attacks. In addition, regulators are requiring financial institutions to develop comprehensive cybersecurity controls. In response, broker-dealers are starting to incorporate AI as an essential component of their cybersecurity programs. A recent research report noted that "sixty-nine percent of organizations believe AI will be necessary to respond to cyberattacks."[28] Incorporating AI into cybersecurity programs may allow firms to assist overwhelmed cybersecurity staff to predict potential attacks, detect threats in real-time, and respond to them faster and at lower costs. Use of AI in cybersecurity programs often begins within insider risk programs where normal behavior can be learned and then deviations or anomalies can be flagged as a risk and reviewed.

Administrative Functions

Another area where AI is being widely used by the securities industry is the automation of administrative functions. Firms are incorporating software augmented by AI technologies (*e.g.*, ML, NLP, and CV) to automate high-volume, less complex, repetitive, and manual tasks that traditionally involve significant human staff time. Firms indicated that automating such tasks with AI tools have the potential of high returns in terms of cost savings and efficiency increases. The following are select examples shared by some broker-dealers of AI use cases for administrative functions:

- **Automation of manual, paper-based processing –** Some firms have deployed AI tools to automate functions that involve manual review of documents, such as processing faxed trade orders, depositing physical checks, and searching, ranking, and retrieving documents. These applications incorporate CV and NLP to identify customers, review signatures, read orders, and digitize documents. Firms indicated that such applications not only increase productivity, but also accelerate important processes, such as trade and payment processing.
- **Document review and information extraction –** NLP enables firms to review significant volumes of documents (*e.g.*, legal contracts, custody documents, and loan agreements) at a fraction of the time it takes for human analysis. In addition to time and cost savings, some firms have indicated that these automated reviews have yielded results with higher accuracy. For example, some firms noted that they use NLP and unsupervised ML to review and classify legal contracts, or to look for certain clauses or key data points within a category of contracts. Another firm noted the use of AI to automate the review of prospectuses for key information, such as expense ratios.
- **Other applications –** Industry participants also indicated they are exploring other areas related to operations where AI tools help to improve the accuracy and efficiency of existing processes, such as reporting and invoice reconciliation.

[28] Capgemini Research Institute, Reinventing Cybersecurity with Artificial Intelligence: The New Frontier in Digital Security, July 11, 2019, PDF.

III. Key Challenges and Regulatory Considerations

AI-based applications offer several potential benefits to both investors and firms, many of which are highlighted in Section II. Potential benefits for investors include enhanced access to customized products and services, lower costs, access to a broader range of products, better customer service, and improved compliance efforts leading to safer markets. Potential benefits for firms include increased efficiency, increased productivity, improved risk management, enhanced customer relationships, and increased revenue opportunities.

However, use of AI also raises several concerns that may be wide-ranging across various industries as well as some specific to the securities industry. Over the past few years, there have been numerous incidents reported about AI applications that may have been fraudulent, nefarious, discriminatory, or unfair, highlighting the issue of ethics in AI applications. As such, several organizations have established initiatives or developed principles to promote the ethical use of AI.[29]

AI-based applications present some particular challenges that securities market participants may wish to consider as they explore and adopt related technology tools. Specifically, where applicable, factors for market participants to consider when seeking to adopt AI-based applications include model risk management, data governance, customer privacy, and supervisory control systems. Other factors for potential consideration include cybersecurity, outsourcing/vendor management, books and records, and workforce structure. This section provides a brief discussion of each of these factors and highlights certain related regulatory considerations.[30]

While this section highlights certain key thematic areas, it is not meant to be an exhaustive list of all factors or regulatory considerations associated with adopting AI-based applications. Broker-dealers should conduct their own assessments of the implications of AI tools, based on their business models and related use cases.

Model Risk Management

Firms that employ AI-based applications may benefit from reviewing and updating their model risk management frameworks to address the new and unique challenges AI models may pose. These challenges may include those related to model explainability, data integrity, and customer privacy. Model risk management becomes even more critical for ML models due to their dynamic, self-learning nature.

A comprehensive model risk management program typically includes areas such as model development, validation, deployment, ongoing testing, and monitoring. Where applicable, the following are potential areas for firms to consider as they update their model risk management programs to reflect the use of AI models:

- Update model validation processes to account for complexities of an ML model.[31] This includes reviewing the input data (*e.g.*, review for potential bias), the algorithms (*e.g.*, review for errors), any parameters (*e.g.*, verify risk thresholds), and the output (*e.g.*, determine explainability of the output).

[29] For instance, in Apr. 2019, the European Commission published a set of non-binding "Ethics guidelines for trustworthy AI", prepared by the Commission's High-Level Expert Group on AI. European Commission, Ethics Guidelines for Trustworthy AI, April 8, 2019, Article.

[30] Supra note 1. While the paper highlights certain regulatory and implementation areas that broker-dealers may wish to consider as they adopt AI, the paper does not cover all applicable regulatory requirements or considerations. FINRA encourages firms to conduct a comprehensive review of all applicable securities laws, rules, and regulations to determine potential implications of implementing AI-based applications.

[31] Model validation refers to "the set of processes and activities intended to verify that models are performing as expected, in line with their design objectives and business uses. Effective validation helps to ensure that models are sound, identifying potential limitations and assumptions and assessing their possible impact." Board of Governors of the Federal Reserve System, Supervisory Letter (SR 11-7) on Guidance on Model Risk Management, Apr. 4, 2011, Article.

- Conduct upfront as well as ongoing testing, including tests that experiment with different and stressed scenarios (*e.g.*, unprecedented market conditions) and new datasets.
- Employ current and new models in parallel and retire current models only after the new ones are thoroughly validated.
- Maintain a detailed inventory of all AI models, along with any assigned risk ratings such that the models can be appropriately monitored and managed based on their risk levels.
- Develop model performance benchmarks (*e.g.*, number of false negatives) and an ongoing monitoring and reporting process to ensure that the models perform as intended, particularly when the models involved are self-training and evolve over time.

Model Explainability

Many ML models allow for some level of explainability with respect to the underlying assumptions and factors considered in making a prediction. Some ML models, however, are described as "black boxes"[32] because it may be difficult or impossible to explain how the model works (*i.e.*, how its predictions or outcome are generated).[33]

While firms indicated that operational deployment of black box models in the near term within the securities industry was unlikely, they also noted that some cutting-edge applications of AI had presented explainability challenges.

An appropriate level of explainability may be particularly important in AI applications that have autonomous decision-making features (*e.g.*, deep learning-based AI applications that trigger automated investment decision approvals). Against this backdrop, firms noted that their compliance, audit, and risk personnel would generally seek to understand the AI-models to ensure that they conform to regulatory and legal requirements, as well as the firms' policies, procedures, and risk appetites before deployment.

FINRA Rule 3110 (Supervision) requires firms to establish and maintain a system to supervise the activities of its associated persons that is reasonably designed to achieve compliance with the applicable securities laws and regulations and FINRA rules. This rule applies to all activities of a firm's associated persons and its businesses, regardless of the use of technology. As such, in supervising activities related to AI applications, firms have indicated that they seek to understand how those applications function, how their outputs are derived, and whether actions taken pursuant to those outputs are in line with the firm's legal and compliance requirements.

The following are some potential areas for firms to consider, as applicable, when establishing policies and procedures that address concerns related to explainability.

- Incorporating explainability as a key consideration in the model risk management process for AI-based applications. This may involve requiring application developers and users to provide a written summary of the key input factors and the rationale attributed to the outputs. The

[32] In its February white paper, the European Commission also noted the 'black box effect' as one of its top concerns: "opacity, complexity, unpredictability, and partially autonomous behavior may make it hard to verify compliance with, and may hamper the effective enforcement of, rules of existing EU law." European Commission, White Paper on Artificial Intelligence – A European Approach to Excellence and Trust, Feb. 19, 2020, PDF.

[33] In simple machine learning models (e.g., models that use traditional statistical methods, such as logistic regression or decision trees), one can follow the logic used by the models and the factors that contribute to the final outcome. However, more complex models (e.g., deep learning models) involve multiple layers and a dynamic, iterative learning process, where the internal learnings are opaque, making it difficult to identify the specific factors and their interrelationships that lead to the final outcome. Despite the challenges, these more complex AI models continue to garner interest from the industry because they offer the potential to be more powerful in identifying patterns and making more precise predictions relative to simpler models.

models can then be tested independently by the model validation teams or by external parties. Some firms noted that they test certain ML models using techniques that involve isolating specific data variables or features in the model to determine their impact on the output. For instance, if eliminating an important feature does not significantly change the output, it may indicate that the model is not appropriately incorporating that feature in the decision-making. Some firms also noted introducing new datasets during the model validation process to ensure that the model operates consistently. However, in considering factors around explainability, it is important to guard against ex-post rationalization of ML models based on correlations that may not link to any underlined causality.[34]

- Building a layer of human review of the model outputs, where applicable, to ensure that the results are in line with business goals, as well as firms' internal policies, procedures, and risk appetite. In our discussions with industry participants, the vast majority noted that their ML-based applications do not involve autonomous action but are instead used to aid human decision-making.
- Establishing appropriate thresholds and guardrails, where ML models trigger actions autonomously. For example, some firms exploring ML for trading applications indicated that they have risk-based limitations built into those applications, such as amount or threshold limits for trade orders.

There are several efforts underway in the financial services industry, as well as more broadly, to develop tools that can provide transparency and explainability for AI models. One such notable effort is the Explainable AI (XAI) program undertaken by the Defense Advanced Research Project Agency (DARPA) to "[p]roduce more explainable models, while maintaining high levels of learning performance (prediction accuracy); and [e]nable human users to understand, appropriately trust, and effectively manage the emerging generation of artificially intelligent partners."[35]

Data Governance

Data is the lifeblood of any AI application. AI applications benefit from large amounts of data to train and retrain models, conduct comprehensive analyses, identify patterns, and make predictions. Accordingly, the quality of the underlying dataset is of paramount importance in any AI application.

Industry participants noted that one of the most critical steps in building an AI application is to obtain and build the underlying database, such that it is sufficiently large, valid, and current. Depending on the use case, data scarcity may limit the model's analysis and outcomes, and could produce results that may be narrow and irrelevant. On the other hand, incorporating data from many different sources may introduce newer risks if the data is not tested and validated, particularly if new data points fall outside of the dataset used to train the model. In addition, continuous provision of new data, both in terms of raw and feedback data, may aid in the ongoing training of the model.

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[34] Several research studies have noted that data mining can lead to incorrect or misleading results because of the identification of spurious correlations. See, for instance, Hou, Kewei and Xue, Chen and Zhang, Lu, Replicating Anomalies, Working Paper No. 2017-03-010 presented at the 28th Annual Conference on Financial Economics and Accounting, Fisher College of Business, June 12, 2017, Article.

[35] Matt Turek, Explainable Artificial Intelligence (XAI), Defense Advanced Research Projects Agency, Article.

Data Bias

Data integrity is a key area of consideration for ML models. An important factor for maintaining data integrity centers on considering issues of data bias.[36] One component of data bias involves data sets that may not include relevant information or include a skewed subset of information, resulting in potential distortions in the output produced by ML models. To limit the potential for this type of data bias it is helpful to have data that is complete, current, and accurate. Another component of data bias involves issues around demographic biases.[37] Such biases may relate to individuals or institutions and may exist in data due to historical practices and could foster discriminatory outcomes if not appropriately addressed.[38]

Data bias, in general, may also be inadvertently introduced during the data preparation process, as data scientists determine which data fields and related features to incorporate in the ML model. Any biases in the underlying data may propagate through the ML model and may lead to inappropriate decision-making.

FINRA Rule 2010 requires firms, in the conduct of their business, to observe high standards of commercial honor and just and equitable principles of trade. These general requirements apply to activity engaged by the firm including, where applicable, those resulting from AI applications.

When reviewing and modifying data governance policies and procedures to address potential data-related risks that may emerge in AI applications, some areas for consideration, where applicable, include:

- **Data review for potential bias –** When building an AI application, it is important to review the underlying dataset for any potential built-in biases. Some firms undertake steps during the testing process to review for potential biases. For example, some firms adjust or eliminate certain data features of the AI model to see how the changes impact the model output. Using such data filters may provide indications of potential biases in the model output based on those features. Testing the models using proxies instead of demographic data is another technique that may reveal potential biases. Firms may also involve multiple participants representing different functions to review the dataset as well as to test the outputs of the models. Recent reports have noted that introducing diversity in the staffing teams that build and test AI systems may provide wider perspectives and enhanced reviews for potential bias in the data. "A more diverse AI community would be better equipped to anticipate, review and spot bias and engage communities affected." Furthermore, providing training on this issue to all individuals that are involved in the development and testing process will likely make them more cognizant of the issue. Firms may also consider using open-source tools created by large technology companies to assist in identifying unwanted bias in data.[41]
- **Data source verification –** AI models often incorporate data from both internal and external sources. As firms compile data, many indicated that they regularly review the legitimacy and authoritativeness of data sources. This is particularly important where the data is obtained from external sources (*e.g.*, open-source data libraries, market data providers, data aggregators, and social media channels). When sourcing data from open source platforms or social media, firms benefit from incorporating appropriate verification steps, particularly given the proliferation of deep fakes[42] and social media manipulation.[43]

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[36] Digital Challenges: Overcoming Barriers to AI Adoption, May 28, 2019, Article (in which EY and Massachusetts Institute of Technology conducted a survey at the 2019 EmTech Digital Conference, and found that "42% cite a lack of quality, unbiased data as the greatest barrier to AI adoption.").

[37] For example, Federal Study Confirms Racial Bias of Man Facial Recognition Systems, Casts Doubt on Their Expanding Use, The Washington Post, Dec. 19, 2019, Article.

- **Data integration –** As firms tap into various data sources to power their AI applications, they seek to obtain and integrate the data effectively into their systems so that it can be leveraged across their organizations. While traditionally, data may have resided in silos in different parts of their organizations, firms are now creating central data lakes to ensure consistency in data usage, to maintain appropriate entitlement and access levels, and to create synergies in data usage.
- **Data security –** Another key consideration is the security of the data that is made available to various stakeholders, both internal and external, in order to develop, test, and use AI applications. It is critical that firms develop, maintain, and test appropriate entitlement, authentication, and access control procedures, as well as use encryption techniques for sensitive data. As discussed in the following section, ensuring customer data privacy is a key objective in establishing data security measures.
- **Data quality benchmarks and metrics –** As part of a comprehensive data governance strategy, firms may also wish to consider developing and monitoring benchmarks and metrics to measure and assess the effectiveness of their data governance programs.

Customer Privacy

AI applications used in the securities industry may involve the collection, analysis, and sharing of sensitive customer data, as well as ongoing monitoring of customer behavior. For example, AI-based customer service tools may involve collection and use of personally identifiable information (PII) and biometrics. Similarly, certain customer focused AI applications monitor information, such as customer website or app usage, geospatial location, and social media activity. Some tools also involve recording written, voice, or video communications with customers. While AI tools based on these types of information may offer firms insights into customer behavior and preferences, they also may pose concerns related to customer privacy if the information is not appropriately safeguarded. Broker-dealers benefit from considering the applicability of relevant customer privacy rules when developing and using such applications, both with respect to the data that is used in AI models and the information that is made available by their outputs.

Protection of financial and personal customer information is a key responsibility and obligation of FINRA member firms. As required by SEC Regulation S-P (Privacy of Consumer Financial Information and Safeguarding of Personal Information), broker-dealers must have written policies and procedures in place to address the protection of customer information and records.[44] In addition, as detailed in *NASD Notice to Members 05-49* (Safeguarding Confidential Customer Information), firms are required to maintain policies and procedures that address the protection of customer

[38] Over the last few years, there have been several reports and notable incidents across various industries of ML models producing allegedly biased and discriminatory results. For example, the European Commission, in its February 2020 white paper, noted its concern about bias and discrimination: "The use of AI can affect the values on which the EU is founded and lead to breaches of fundamental rights, including the rights to freedom of expression, freedom of assembly, human dignity, nondiscrimination based on sex, racial or ethnic origin, religion or belief, disability, age or sexual orientation, as applicable in certain domains, protection of personal data and private life, or the right to an effective judicial remedy and a fair trial, as well as consumer protection. These risks might result from flaws in the overall design of AI systems… or from the use of data without correcting possible bias…" European Commission, White Paper on Artificial Intelligence – A European Approach to Excellence and Trust, Feb. 19, 2020, PDF.

[39] Rubin Nunn, Workforce Diversity Can Help Banks Mitigate AI Bias, American Banker, May 30, 2018, Article. See also, Jake Silberg & James Manyika, Tackling Bias in Artificial Intelligence (and in Humans), June 2019, Article.

[40] James Manyika et al, What Do We Do About the Biases in AI?, Harvard Business Review, Oct. 25, 2019, Article.

[41] Some examples of tools that reportedly assist in identifying potential bias in data include IBM's AI Fairness 360 and Google's Responsible AI Practices.

[42] Deep fakes refer to a form of synthetic or manipulated communication in which an existing video, image, or audio clip is replaced or superimposed with someone else's likeness in order to create false impressions or communications.

[43] FINRA, Social Sentiment Investing Tools – Thing Twice Before Trading Based on Social Media, Apr. 2019, Article.

[44] U.S. Securities and Exchange Commission, Final Rule: Privacy of Consumer Financial Information (Regulation S-P), Article.

information and records, and ensure that their policies and procedures adequately reflect changes in technology. Firms also should provide initial and annual privacy notices to customers describing information sharing policies and informing customers of their rights. Additionally, SEC Regulation S-ID (the Red Flags Rule) requires broker-dealer firms that offer or maintain covered accounts to develop and implement written "Identity Theft Prevention Programs." Moreover, numerous international, federal, and state regulations and statutes set forth specific rules and requirements related to customer data privacy. Firms should assess the applicability of these laws as they build their AI applications and any underlying infrastructures.

Firms also should update their written policies and procedures with respect to customer data privacy, to reflect any changes in what customer data and information is being collected in association with AI applications, and how that data is collected, used, and shared. In this regard, below are some questions for firms to consider.

- Have appropriate consents been obtained from customers to track, collect, and monitor their information, including information obtained directly from customers (*e.g.*, PII and biometrics) as well as other sources (*e.g.*, website usage, social media platforms, or third-party vendors)?
- Has the applicable data been authorized for each relevant use case related to an AI application?
- Have user entitlements and access procedures been updated as new, shared databases or centralized data lakes are created?
- Has sensitive data been obfuscated[45] (as needed) and does the data continue to remain protected as it is applied across different AI applications?
- Has the data governance framework been appropriately updated to reflect any changes related to customer data privacy policies and procedures?

Supervisory Control Systems

FINRA rules require firms to establish and maintain reasonable supervisory policies and procedures related to supervisory control systems in accordance with applicable rules (*e.g.*, FINRA Rules 3110 and 3120). This includes having reasonable procedures and control systems in place for supervision and governance of AI-based tools and systems across applicable functions of a broker-dealer.

As discussed earlier in this report, use of AI-based applications may pose unique and complex challenges, such as those related to model explainability and bias. As noted in FINRA's 2020 Risk Monitoring and Exam Priorities Letter, "Firms' increasing reliance on technology for many aspects of their customer-facing activities, trading, operations, back-office, and compliance programs creates a variety of potential benefits, but also exposes firms to technology-related compliance and other risks."

As broker-dealer firms employ AI-based tools and services across the firm, they should update and test related supervisory procedures and reflect those updates in their written supervisory procedures (WSPs). In addition to the topics discussed earlier in this report, some areas for consideration, where applicable, when adopting AI applications are noted below.[46]

[45] Obfuscation may be accomplished with encryption, tokenization, or anonymization techniques.

[46] These are some of many possible areas that broker-dealers may wish to consider as they explore adjusting their supervisory processes. This does not express any legal position, does not create any new requirements or suggest any change in any existing regulatory obligations, nor does it provide relief from any regulatory obligations. It is not intended to cover all applicable regulatory requirements or considerations. FINRA encourages firms to conduct a comprehensive review of all applicable securities laws, rules, and regulations to determine potential implications of implementing AI-based tools and systems.

- **Establish a cross-functional technology governance structure –** As previously stated by FINRA, firms may find it beneficial to establish a cross-disciplinary technology governance group to oversee the development, testing, and implementation of AI-based applications.[47] Such a group could include representation from different functions across the organization, including business, technology, information security, compliance, legal, and risk management. FINRA has previously stated in the trading context that: "[A]s the use of algorithmic strategies has increased, the potential of such strategies to adversely impact market and firm stability has likewise grown. When assessing the risk that the use of algorithmic strategies creates, firms should undertake a holistic review of their trading activity and consider implementing a cross-disciplinary committee to assess and react to the evolving risks associated with algorithmic strategies."[48]
- **Conduct extensive testing of applications –** Testing new tools and applications across various stages of their lifecycle can help identify potential concerns in a timely manner and limit potential issues. This could involve extensive testing of the applications by various user groups, and by using new data sets and new scenarios in the testing process. In addition, this could also include maintaining existing parallel systems as firms test new ones.
- **Establish fallback plans –** Establishing back-up plans in the event an AI-based application fails (*e.g.*, due to a technical failure or an unexpected disruption) can help ensure that the relevant function is carried on through an alternative process. FINRA Rule 4370 (Business Continuity Plans and Emergency Contact Information) requires firms to create and maintain a written business continuity plan with procedures that are reasonably designed to enable firms to meet their obligations to customers, counterparties, and other broker-dealers during an emergency or significant business disruption.
- **Verify personnel registrations –** The skillsets of securities industry personnel are evolving rapidly to keep pace with the adoption of emerging technologies. Technical and operational roles are starting to blend, as information technologists and data scientists are playing key roles in operational functions like trading and portfolio management. Firms may need to evaluate the roles of these personnel to ensure that they have the appropriate FINRA licenses and registrations. For instance, as stated in *Regulatory Notice 16-21*, FINRA requires registration of associated persons involved in the design, development, or significant modification of algorithmic trading strategies. Furthermore, FINRA Rule 1220(b)(3) and *FINRA Regulatory Notice 11-33* state that certain firm personnel engaged in "back office" covered functions must qualify and register as Operations Professionals.

AI technology has the potential to disrupt and transform supervisory functions within a broker-dealer. Firms may benefit from conducting an overall assessment of the functions and activities that are employing AI-based tools, and updating their supervisory procedures accordingly. The following are examples of some areas that firms may wish to review.

- **Trading applications:** FINRA has previously stated in *Regulatory Notice 15-09*, "In addition to specific requirements imposed on trading activity, firms have a fundamental obligation generally to supervise their trading activity to ensure that the activity does not violate any applicable FINRA rule, provision of the federal securities laws or any rule thereunder." As firms adopt AI algorithms and strategies in their trading functions, they benefit from reviewing and testing their supervisory controls to ensure that there is continued compliance with applicable rules and regulations, including but not limited to FINRA Rules 5210 (Publication of Transactions and Quotations), 6140 (Other Trading Practices) and 2010 (Standards of Commercial Honor and Principles of Trade), SEC Market Access Rule, and SEC Regulation NMS, Regulation SHO and Regulation ATS.

[47] FINRA RegTech White Paper.

[48] FINRA, Regulatory Notice 15-09 on Effective Supervision and Control Practices for Firms Engaging in Algorithmic Trading Strategies, Mar. 2015, Article.

- **Funding and liquidity risk management:** As firms employ AI applications across functions like liquidity and cash management, portfolio management, and trading, they may wish to consider reviewing their supervisory procedures to ensure that the applications and the underlying models incorporate appropriate risk thresholds and relevant regulatory requirements, and do not create an environment of excessive risk-taking. This is particularly relevant where AI tools are used for liquidity and cash management, cases in which the models may generate aggressive recommendations for liquidity and leverage or may lead to unsound recommendations in unforeseen or stressed situations. As firms review their supervisory procedures, some factors to review include adequacy of existing controls, monitoring tools, and reporting tools to manage such risks. As previously stated in *Regulatory Notice 15-33*, "As part of a firm's obligation to supervise the businesses in which it engages, FINRA expects each firm to regularly assess its funding and liquidity risk management practices so that it can continue to operate under adverse circumstances, whether these result from an idiosyncratic or a systemic event." Further, as stated in *Regulatory Notice 10-57*, "FINRA expects broker-dealers affiliated with holding companies to undertake these efforts at the broker-dealer level, in addition to their planning at the holding-company level."[49]
- **Investment advice tools:** Market participants are exploring the use of AI tools that generate client risk profiles and potential investment recommendations. These tools may aid in developing a new investment strategy, rebalancing portfolios, suggesting specific products or asset classes, or offering tax-minimization strategies. Market participants may benefit from considering how SEC Regulation Best Interest (BI) and FINRA Rule 2111 (Suitability) would apply in these contexts. In addition, as noted in FINRA's Report on Digital Investment Advice, firms should ensure "sound governance and supervision, including effective means of overseeing suitability of recommendations, conflicts of interest, customer risk profiles and portfolio rebalancing."

Additional Considerations

- **Cybersecurity –** As noted in Section II of this report, cybersecurity continues to be a key threat for the financial services industry. While AI technology empowers the industry to identify potential security threats and attacks in real-time, use of related applications may also pose new vulnerabilities and threats. For instance, AI-based applications that pull in data from multiple sources may expose the firm to new security risks. In addition, customer-facing tools offered by firms on third-party platforms (*e.g.*, virtual assistants offered on third-party consumer devices) could also pose security risks, such as those introduced through vulnerabilities of those third-party platforms or through inadequate customer authentication procedures. Firms would benefit from incorporating cybersecurity as a critical component of the evaluation, development, and testing process of any AI-based application. For additional resources on this topic, including applicable rules, guidance, and FINRA's report on Cybersecurity Practices, refer to FINRA's webpage on cybersecurity.

[49] FINRA, Regulatory Notice 10-57 on Funding and Liquidity Risk Management Practices, Notice; FINRA, Regulatory Notice 15-33 on Guidance on Liquidity Risk Management Practices, Notice.

- **Outsourcing and vendor management –** As firms look to take advantage of the benefits offered by AI-based tools, many are choosing to outsource specific functions or purchase turnkey applications from vendors. Some vendors are developing niche products that leverage AI for specific activities (*e.g.*, financial crime monitoring and trade surveillance). Use of such vendor tools can be appealing to both small and large firms that seek to implement AI-based technology with low upfront capital investment and faster implementation time.[50] Firms are reminded that outsourcing an activity or function to a third-party does not relieve them of their ultimate responsibility for compliance with all applicable securities laws and regulations and FINRA rules. As such, firms should review and update their WSPs to ensure that they appropriately address outsourcing arrangements (see, *e.g.*, *Notice to Members 05-48 (Outsourcing)*) and to ensure that the security of the third-party meets or exceeds that expected by the firms. Firms may also wish to consider introducing language in contracts with third-party vendors that includes, but is not limited to, requiring vendors to notify firms in the event of a security breach and giving firms the right to audit, including the ability to review third-party System and Organization Controls (SOC) reports.
- **Books and records –** The use of AI applications may lead to the creation of new records. Firms should review the use of their AI tools and systems to ensure compliance with recordkeeping obligations, such as those associated with Exchange Act Rules 17a-3 and 17a-4 and FINRA Rule 4510 (Books and Records Requirements). For example, the use of AI tools with respect to chatbots and virtual assistants may create novel issues in the context of compliance with applicable recordkeeping requirements.
- **Workforce structure –** Adoption of AI tools and services could potentially impact a firm's workforce in multiple ways. AI-based applications may conduct certain tasks previously performed manually in a more effective manner and in a fraction of the time. This could result in a reduced number of jobs in certain skillsets and an increased number in others. This transition may be challenging for many reasons, including that there is a significant shortage of individuals with AI-related skills in the industry.[51] Firms may also face challenges with adjusting the culture of their technology functions as they shift away from a traditional waterfall methodology to a more agile process. Accordingly, as firms seek to adopt AI-based technology tools, they may want to consider reviewing the potential impact on their workforce, and take the appropriate steps to, for example, review any new staffing needs or training required for the use of new applications.

[50] However, some market participants have raised concerns that use of a limited number of vendors to develop AI tools for an industry, if not managed appropriately, may create overreliance and concentrate risks related to errors or malfunctioning of AI systems.

[51] Scott Likens, How Artificial Intelligence Is Already Disrupting Financial Services, Barron's, May 16, 2019, Article (stating that "[A]lmost a third of the financial executives in the AI survey are worried that they won't be able to meet the demand for AI skills over the next five years.").

IV. REQUEST FOR COMMENTS

FINRA encourages comments on this paper, including areas where guidance or modifications to FINRA rules may be desired to support adoption of AI applications while maintaining investor protection and market integrity. Comments are requested by August 31, 2020.

Member firms and other interested parties can submit their comments using the following methods:

- Emailing comments to pubcom@finra.org; or
- Mailing comments in hard copy to: Marcia E. Asquith, Office of the Corporate Secretary, FINRA, 1735 K Street NW, Washington, DC 20006-1506.

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: All comments received in response to this paper will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.

Direct inquiries regarding this paper to Haimera Workie, Senior Director and Head of Office of Financial Innovation, at (202) 728-8097; or Kavita Jain, Director, Office of Financial Innovation, at (202) 728-8128.