Agenda

CEFLI Compliance & Ethics Committee Meeting
Wednesday, April 17, 2019
2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
Dial In: (800) 239-9838
Passcode: 3646069

I. Welcome and Introduction. — Donald J. Walters

A. Antitrust Statement.

II. Approval of Minutes – March 28, 2019 Meeting. — The Committee

III. Issues for Review. — The Committee

A. California Senate Bill 179 - The Gender Recognition Act.

California recently enacted Senate Bill 179 which became effective on January 1, 2019 and requires an applicant when applying for an original driver's license or a renewal driver's license to choose a gender category of female, male or non-binary.

This California law raises an interesting question concerning how life insurance companies may be accommodating applicants who may select a non-binary gender choice in their applications for life insurance and annuity products.

Other states are reportedly considering similar types of legislation.

The Committee will be asked to discuss their company's practices with respect to accommodating applicants who may select a non-binary gender choice in their applications for life insurance and annuity products.

B. Anti-Rebating Laws and Innovation Strategies.

During the recent NAIC Spring National Meeting, the Innovation and Technology (EX) Task Force examined the extent to which anti-rebating laws may serve as a possible impediment to pursuing various innovation strategies.

As an example, scenarios were identified in which insureds may be encouraged to accept certain items, such as a "wearable," that may provide the insurer with a broader range of information that may allow an applicant to qualify for more favorable rates or receive other benefits.

It was acknowledged that only a handful of states maintain anti-rebating laws and other states have recently repealed them. Therefore, the Task Force is examining the question of whether anti-rebating laws are necessary.

A question has been presented concerning the extent to which compliance may be involved in the development of innovation strategies at your company and, more specifically, whether the issue of anti-rebating has impacted decision-making with respect to the implementation of a possible innovation strategy.

The Committee will be asked to discuss the extent to which compliance may be involved in the development of innovation strategies and whether issues associated with anti-rebating laws may have impacted the implementation of a possible innovation strategy.

C. Role of Compliance in Development of Policies and Procedures Related to Social Media, Text Messaging and Other Electronic Communication Methods by Producers.

Over the past several years, life insurance companies have examined their policies and procedures to determine whether to permit producers to use social media, text messaging and other electronic communication methods in communications with customers.

As prevalence of these technologies continues to evolve, companies are continually examining their current policies and procedures in light of increasing demand from producers to utilize a variety of different electronic communication methods with customers.

The Committee will be asked to discuss whether their company conducts a periodic review of their current policies and procedures with respect to the use of social media, text messaging and other electronic communication methods by producers with customers and, if so, to what extent compliance may be involved in decisions to modify and update existing policies and procedures.

D. Staffing Trends within Compliance Departments – Data Scientists/Operations Staff.

Compliance departments continue to hire professionals who possess a range of skills that may not be considered traditional life insurance company compliance skills. For example, it has been reported that many life insurance company compliance departments are building their staffs to attract individuals who possess expertise in non-traditional compliance areas such as data analysis and other quantitative skill sets.

We also recognize that state insurance departments (with the support of the NAIC) maintain a strong interest in building their capacity to be able to conduct more detailed data analysis to inform their market regulation activities. As a result, more and more life insurance company compliance departments are adding individuals with expertise related to data analysis to their existing staff.

Other hiring trends in compliance include training of current operational staff to become compliance professionals within their organizations.

The Committee will be asked to discuss their observations with respect to trends in hiring practices among compliance departments at life insurance companies and whether their companies have considered adding professionals with non-traditional compliance expertise such as data analytics to their existing staff.

E. Identity Verification Practices.

In order to meet a variety of different compliance requirements, life insurance companies take steps to verify the identity of new customers as well as existing customers.

Recognizing that identity verification practices may differ from company to company, a question has been posed to determine what types of tools/software companies may be using to comply with identity verification laws and regulations as well as Know Your Customer rules for various types of transactions.

Specifically, the following questions have been posed:

- *What steps does your company take to verify the identity of customers participating in direct-to-consumer sales?*
- *What steps does your company take to verify the identity of existing customers?*
- *Is the same identity verification process used for new customers as well as existing customers? If not, how do they differ?*

The Committee will be asked to discuss their company's identity verification practices and whether these practices may differ according to the manner in which a product may be sold (i.e., direct-to-consumer sales) or whether these practices may differ for new customers versus existing customers.

F. New York Circular Letter No. 1 - Accelerated Underwriting - Adverse Underwriting Decision Notifications.

The New York Department of Financial Services issued Circular Letter No. 1 earlier this year regarding the use of external consumer data and information sources in underwriting for life insurance. (See copy attached.)

Within the Circular Letter, the New York Department of Financial Services confirmed that:

> *"An adverse underwriting decision would include the inability of an applicant to utilize an expedited, accelerated or algorithmic underwriting process in lieu of a traditional medical underwriting."*

The Circular Letter also references New York Insurance Law §4224 (a)(2) which requires insurers to notify the insured or potential insured of the right to receive the specific reason or reasons for declination, limitation, rate differential or other adverse underwriting decision.

With more insurers exploring strategies to offer accelerated underwriting to applicants for life insurance products, companies operating in New York may have to revise their notifications regarding an adverse underwriting decision to include a decision to require an applicant to forgo accelerated underwriting in lieu of a traditional medical underwriting.

The Committee will be asked to discuss whether their companies may have modified their existing notifications of an adverse underwriting decision to include circumstances where an insured or potential insured would not be eligible to undergo accelerated underwriting in lieu of a traditional medical underwriting.

G. South Carolina Bulletin No. 2019-02 - Rescission of a Life Insurance Policy

South Carolina recently issued Bulletin No. 2019-02 "reminding" life insurers doing business in that state that, per SC Code §38-63-220(d), an insurer can only "vacate" or rescind coverage on an individual life policy by "instituting proceedings." (See copy attached.)

The Bulletin further states: (1) "A proceeding to vacate a policy is a judicial proceeding commenced to cancel the policy or have it declared null and void"; and (2) "Unilateral rescissions of life insurance policies violate South Carolina law."

The language of the Bulletin seems to suggest that all rescissions must be commenced by judicial action (e.g., DJA or other civil actions). However, the Bulletin also states:

"Thus, the South Carolina General Assembly mandated that if an insurer wanted to challenge the truthfulness of the application, it must do so during the first two years of the policy. *After the policy has been in effect for two years, the application cannot be challenged on this basis*." (Emphasis added.)

The Bulletin further states: "A letter or other notice to the <u>insured</u> stating that the policy has been canceled or rescinded does not qualify as a *proceeding to vacate a policy* under South Carolina law." (Underline added.)

This language suggests that, per the Bulletin, the South Carolina Department of Insurance is focused on live rescissions within the first two years from "date of issue."

The Committee will be asked to discuss their views on "unilateral rescission" prohibition, two-year time limit on "challenges" to the truthfulness of the application, and the "judicial proceedings" mandate found within South Carolina Bulletin *No. 2019-02;* ***especially as to whether these requirements apply only to live rescissions or any rescission.***

IV. Reporting Items. CEFLI Staff.

A. NAIC Spring National Meeting.

The NAIC recently conducted its Spring National Meeting in Orlando, Florida.

CEFLI staff will provide a brief overview of key developments arising out of the NAIC Spring National Meeting.

B. UPDATE: New Illinois Law - Sexual Harassment Prevention Training.

During the Committee's March 28 meeting, an issue was presented with respect to a new Illinois Law (20 ILCS 2105/2105/-15.5) that requires sexual harassment prevention training for any profession that has continuing education requirements.

Subsequent to the meeting, a member of the Committee provided guidance indicating that the Illinois Law requiring sexual harassment prevention training was deemed to be inapplicable to the insurance industry.

C. UPDATE: OR Senate Bill 769 - Redacting of Social Security Numbers in Consumer Correspondence and Document Destruction Policies.

Over the past several months, the Committee has discussed the potential compliance implications of a recently enacted Oregon law (ORS § 646A.620) that was read to prohibit the printing, displaying or posting of Social Security numbers on, for example, any mail that is "part of any documentation the consumer requested for a transaction or service, unless the Social Security number is redacted."

With the assistance of John Mangan of the ACLI, we have been able to determine that the Oregon Division of Financial Regulation has confirmed that ORS § 646A.620 does not change the rules of delivery of policies and applications in the life insurance industry.

D. UPDATE: Maryland Fiduciary Standard Legislation Fails.

Maryland recently introduced legislation entitled the Financial Consumer Protection Act of 2019 (SB 786) that would require both registered representatives with broker-dealers and life insurance producers to act as fiduciaries with "a duty to act in the best interest of the customer without regard to the financial or other interest of the person or firm providing the advice."

The Maryland Senate Finance Committee disapproved of the Financial Consumer Protection Act, which included a provision that would impose a fiduciary duty on financial professionals operating in Maryland. Therefore, the legislation failed to get enacted in the 2019 session of the Maryland Legislature.

E. New Jersey Introduces Fiduciary Rule.

The New Jersey State Securities Bureau recently released a rule that would impose a fiduciary duty on broker-dealer registered representatives. (See copy attached.)

The rule proposal would subject registered representatives of broker-dealers (a "broker") operating in New Jersey to a fiduciary standard rather than the current FINRA suitability standard.

A broker who fails to act as a fiduciary would be engaging in an "unethical or dishonest business practice."

Many commenters on a pre-proposal urged New Jersey to wait until the SEC issues its final version of Regulation Best Interest.

Comments on the New Jersey proposed rule are due by June 14.

F. FINRA Chief Legal Officer Sees Changes to Suitability Rule.

Robert Colby, FINRA's Chief Legal Officer, recently indicated that FINRA will either revise its current Suitability Rule once the SEC's Regulation Best Interest is final or will eliminate it entirely.

The goal will be to eliminate any overlap between the SEC's Regulation Best Interest and FINRA's Suitability Rule so Regulation Best Interest and FINRA's Suitability Rule are "completely aligned."

G. House Financial Services Committee Approves Cannabis Safe Harbor Bill for Insurers and Banks.

The House Financial Services Committee recently approved HR 1595, the Secure and Fair Enforcement Banking Act of 2019, which would provide access to financial services for cannabis-related businesses and service providers. An amendment to the legislation included a safe harbor for insurers that wish to provide financial services to cannabis -related businesses and service providers in states that have legalized marijuana.

H. Personnel Matters - Allison Lee Nominated for SEC Vacancy.

President Trump nominated Allison Lee, a former SEC enforcement attorney, for a vacancy on the Securities and Exchange Commission. Ms. Lee was reported to be a favored candidate among many Democrats.

If the Senate confirms Ms. Lee, she would replace Kara Stein, also a Democrat, on the Commission.

V. CEFLI Activities.

A. Next Meeting: Regulation 187 Issue Forum - Thursday, April 25 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT.

The next meeting of the CEFLI Regulation 187 Issue Forum is scheduled to take place on Thursday, April 25 at 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT.

A call for agenda items will be issued within the next several days.

Please mark your calendar and plan to join us.

B. Compliance Fundamentals Training Conference - May 8-10 - Austin, Texas.

On May 8-10, CEFLI will be conducting its Compliance Fundamentals Training Conference at The Driskell Hotel in Austin, Texas.

CEFLI's Compliance Fundamentals Training Conference is available free of charge as part of your company's membership benefits. The Conference is designed to provide education and training for those who may be new to the life insurance industry or those who may be new to the compliance function within a life insurance company.

Registration for the Conference is available online via CEFLI's website. A copy of the preliminary program for the Conference is attached.

We hope to see you in Austin on May 8-10!

C. *New Conference* - National Compliance & Ethics Forum - Des Moines, Iowa - June 12-13.

CEFLI is pleased to introduce a new 2019 CEFLI National Compliance & Ethics Forum. The 2019 National Compliance & Ethics Forum will take place at the Renaissance Savery Hotel in Des Moines, Iowa on June 12-13.

The new 2019 National Compliance & Ethics Forum will consolidate and supplant our previous Regional Compliance Forums.

Like our previous Regional Compliance Forums, the agenda for the National Compliance & Ethics Forum will be developed through the submission of issues for discussion by those who register to attend the Forum. Participation will be limited exclusively to member company representatives to establish an open environment for our discussions.

The 2019 CEFLI National Compliance & Ethics Forum is free of charge to all CEFLI member company representatives as a benefit of your company's CEFLI membership.

Registration to attend the Forum is now available via the CEFLI website.

You also may make hotel reservations at the Renaissance Savery Hotel through the following link:

https://www.marriott.com/event-reservations/reservation-link.mi?id=1555102840077&key=GRP&app=resvlink

We hope you will be able to join us in Des Moines on June 12-13 for this unique opportunity to "connect" with your fellow industry professionals from across the country!

D. Upcoming Privacy Webinar - Wednesday, March 27.

CEFLI will be conducting a webinar on Replacements on Wednesday, March 27 at 1 PM EDT/12 Noon CDT/11 AM MDT/10 AM PDT.

CEFLI staff will provide a brief report concerning the highlights of the Replacements webinar.

VI. Next Meeting.

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

May 15, 2019 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT

The Committee will hold its remaining 2018 meetings as follows:

June 11, 2019 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
July 24, 2019 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
August 14, 2019 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
September 25, 2019 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
October 16, 2019 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
November 13, 2019 - 2 PM EST/1 PM CST/12 Noon MST/11 AM PST
December 18, 2019 - 2 PM EST/1 PM CST/12 Noon MST/11 AM PST

Please mark your calendar and plan to join us!

VII. Other Business.

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

DRAFT

Minutes
Meeting of the
CEFLI Compliance & Ethics Committee
March 28, 2019
2 PM EDT/1 PM CDT/11 AM PDT

A meeting of the CEFLI Compliance & Ethics Committee (the "Committee") was held via conference call on Thursday, March 28, 2019 at 2 PM EDT/1 PM CDT/11 AM PDT.

The following CEFLI member company representatives participated in the meeting:

Molly Akin, Ohio National
Renee Ambrosy, CNO Financial
Shannon Aussieker, Country Companies
Jenna Austin, Guggenheim Life
Brendan Bakala, Catholic Order of Foresters
Chad Batterson, Athene USA
Donna Beattie, State Farm Life
Ann Binzer, Cincinnati Life
Kate Blaylock, Western & Southern
Bryan Brewster, Wilton-Re
Kara Busener, Western & Southern
Nancy Campbell, Symetra Life Insurance Company
Andrea Christensen, Sagicor Life
Alayna Cook, MassMutual
Allison Corrado, Lombard International
John Cunningham, Fidelity Investments
Kathy Deputy, State Farm Life
Bruce Eschbach, Texas Life
Chad Eslinger, Voya Financial
Lynn Espeland, Woodmen of the World
Rita Fenani, Pacific Life
Jill Fiddler, Assurity Life
Jamie Fournier, MassMutual
Paula Gentry, Cincinnati Life
Jennifer Gibb, Pacific Life
Andrew Gnatek, MassMutual
Dennis Herchel, SBLI of Massachusetts

Lisa Holland, State Farm Life
Michelle Holmes, Voya Financial
Donna Hough-Zukas, SunLife
Belinda Howard, Principal Life
Nathan Huff, Sammons
Kerry Hurley, MassMutual
Jill Jones, Bankers Fidelity
Samantha Knackmuhs, State Farm
Michele Kulish Danielson, American Enterprise
Marla Lacey, Homesteaders Life
Brian Leary, Fidelity Investments Life
Dan Leblanc, SBLI of Massachusetts
Laurie Lewis, Amica Life
Chris McAuliffe, SBLI Of Massachusetts
Dave Milligan, American Equity
Morgan Milner, Modern Woodmen
Jim Odland, Thrivent
Sabrina Olender, Foresters Financial
Monique Pascual, Pacific Guardian Life
Liza Perry, USAA Life
Megan Phillips, Principal Life
Tony Poole, AAA Life
Sandra Ray, Symetra Life Insurance Co
Daniel Reinecke, Gerber Life
Michelle Ross, Lombard International
Sally Roudebush, Lincoln Heritage
Heather Russo, Illinois Mutual
Cara St Martin, Allianz Life
Angie Schneider, Cincinnati Life
Ryan Schwoebel, Protective Life
Conrad Seibert, Securian Financial
John Sharp, Assurity Life
Devin Smith, Securian Financial
Stephen Smith, Protective Life
Jill Terry, Cincinnati Life
Kristen Thomas, Jackson National
Bill Turner, American Fidelity Assurance
Laura VanLaningham, Illinois Mutual
Rochelle Walk, Wilton Re
Michelle Ward, Erie Life
Larry Welch, Citizens Inc.
Tracy Whitaker, Homesteaders Life
Stacey White, American National
Emily Wilburn, Illinois Mutual

Mallory Bennett, Kelly Ireland and Donald Walters of CEFLI also participated in the meeting.

I. Welcome and Introduction.

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

II. Approval of Minutes – February 13, 2019 Meeting.

On motion, duly made and seconded and unanimously carried, the Committee: RESOLVED, that, the Minutes of the February 13, 2019 meeting are hereby approved.

III. Issues for Review.

A. Compliance Testing - Organizational Structure.

As part of a comprehensive enterprise risk management strategy, companies test compliance systems to ensure that they are operating appropriately within their businesses.

The Committee was asked to discuss their compliance strategies and organizational structures associated with “compliance testing.”

Several Committee members indicated that the Compliance Department has responsibility for compliance testing, while others reported that Compliance partners with other business units with some testing being conducted by the business unit itself.

Though compliance testing may reside in Compliance, Committee members with this structure indicated working closely with Risk Management and Internal Audit to coordinate and avoid double testing. Part of this coordination may involve determining which subject matters will be tested throughout the year. Some areas such as replacements, newly enacted laws and market conduct exam findings are tested every year, while others may be tested more/less often depending on the level of risk.

Some Committee members indicated that they outsource some of their compliance testing (e.g., operational issues).

A Committee member reported having a Regulatory Team in place to test their compliance with newly enacted legislation and regulations.

A Committee member indicated that they have built quality review functions and quality assurance testing into their process to ensure compliance is timely and correct.

B. Illinois Law - Sexual Harassment Training.[1]

Illinois recently passed a new law (20 ILCS 2105/2105/-15.5) that requires sexual harassment prevention training for any profession that has continuing education requirements.

The Committee was asked to discuss the implications of the new Illinois law regarding sexual harassment prevention training and whether they plan to implement appropriate training for their employee producers.

C. Single Premium Immediate Annuities and Buyer's Guides.

The Committee was asked to discuss their company's practices concerning the use of Buyer's Guide in sales of single premium immediate annuities ("SPIA").

A Committee member reported that, while they do sell SPIAs, they rely on the fact that most state requirements exclude "immediate and deferred annuities that contain no nonguaranteed elements" and do not provide a Buyer's Guide.

D. NAIC Privacy of Consumer Financial and Health Information Model Regulation.

In 2017, the NAIC adopted amendments to its Privacy of Consumer Financial and Health Information Model Regulation. This Model Regulation implements the privacy requirements of the Graham Leach Bliley Act ("GLBA") for insurers.

The amendments to the Model Regulation included a Model Privacy Form developed by federal regulators as a template for GLBA privacy notices for federally regulated financial institutions.

The amendments also included a compliance "safe harbor" for use of the federal Model Privacy Form. The compliance "safe harbor" for the use of privacy notice sample clauses found in the original Model Regulation is due to expire on July 1, 2019.

The Committee was asked to discuss their compliance strategies concerning whether they plan to modify their existing GLBA privacy notices to incorporate the federal Model Privacy Form that is eligible for the compliance "safe harbor" under the 2017 amendments to the Model Regulation.

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[1] Subsequent to the March 28th meeting, a member of the Committee contacted their company's licensing vendor, who, in turn, contacted the Illinois Department of Insurance and was advised that this new Illinois law requiring sexual harassment prevention training is inapplicable to the insurance industry.

A Committee member reported that the new Colorado privacy regulation adopted the 2017 amendments to the Model Regulation and companies will lose the "safe harbor" for old privacy notices on July 1st of this year. When analyzing whether to adapt their privacy notice to incorporate the federal form and retain the safe harbor, they found that the form does not work well for insurers as it is more bank-centric. There was concern that the federal form would be too big of a departure from their current privacy notice and may alarm consumers, so the company has decided to wait and see whether additional states adopt the amendments to the Model Regulation before taking further action.

E. New York's Cybersecurity Regulation - Third Party Service Providers.

New York's Cybersecurity Regulation (23 NYCRR 500) requires covered entities, such as life insurers, to implement written policies and procedures designed to ensure the security of information systems that are accessible by Third-Party Service Providers, which includes independent producers.

The Committee was asked to discuss their strategies to address the requirements of New York's Cybersecurity Regulation as it relates to Third-Party Service Providers.

A Committee member indicated that their IT Security area runs their procurement process and will incorporate new questions to ask third-party service providers to comply with NY's requirements.

Another Committee member indicated that they have revised their third-party service providers' contract to include the NY requirements. At time of contracting they will ask service providers to complete a questionnaire, will create a risk profile and may conduct an onsite visit. Once a contract is in place, the company will monitor and engage with the service provider if they see anything of concern and discuss what mitigating practices may be appropriate.

A Committee member reported that they are using BitSight, which was developed by an MIT professor, to address this cyber-risk.

F. Market Conduct Inquiry - Missouri - Life Insurance Policies with "Health" Riders.

It has been reported that the Missouri Department of Insurance has been asking insurers to provide copies of life insurance policies with "health" riders (such as critical illness, accident, specified disease, hospital expense and disability).

The Committee was asked to discuss whether any companies have received a similar request from the Missouri Department of Insurance and whether there may be any explanation as to why the request is being made.

A Committee member reported that they had just received this inquiry from MO and were given a short time frame to respond by April 1st. The company has older life products with health riders on them previously approved in MO and believes the inquiry may be a due to a misunderstanding by an analyst because MO requires these riders to be offered with health products, but not with life policies.

G. Vendor Recommendations.

The Committee was asked to discuss whether they may have vendor recommendations to address administering employee conflict of interest compliance statements or providing fraud training.

Some committee members reported using Articulate Storyline software, an online learning management tool to develop their annual conflict of interest training/review, which is administered by the HR department. Once employees have reviewed the content (which is customizable), they are required to sign their agreement with the conflict of interest statement.

With respect to antifraud training, vendors used by Committee members include North American Training Group, which has a module for training required in CA and offers CT elder abuse training. Fraudeducation.com has an online catalogue and offers CT elder abuse training.

IV. Reporting Items.

A. A. OR Senate Bill 769 - Redacting of Social Security Numbers in Consumer Correspondence and Document Destruction Policies.

CEFLI staff reported that John Mangan of the ACLI (ACLI's Oregon state representative) will be meeting with representatives of the Oregon Insurance Administration this week to discuss the operational challenges associated with Oregon Senate Bill 769.

CEFLI staff will report back on any further developments learned.

B. Maryland Introduces Fiduciary Standard Legislation.

CEFLI staff reported that Maryland recently introduced legislation that would require both registered representatives with broker-dealers and life insurance producers to act as fiduciaries with "a duty to act in the best interest of the customer without regard to the financial or other interest of the person or firm providing the advice."

The Maryland legislation follows similar initiatives that have been introduced in Nevada, New Jersey and Washington.

Financial services industry advocates have been encouraging states to refrain from imposing a fiduciary standard until the SEC proposes a final version of its Regulation Best Interest in order to provide a uniform, national standard.

C. NYDFS Consumer Alert on Universal Life Insurance.

CEFLI staff reported that the New York Department of Financial Services recently issued a Consumer Alert on Universal Life Insurance.

The Consumer Alert explains universal life insurance products and alerts consumers that their premium amounts may increase.

D. FINRA Disciplinary Actions Decline While Average Fines Rise.

CEFLI staff reported that FINRA initiated fewer disciplinary actions in 2018 (as compared to 2017) but the average fines rose to $107,000 from $65,000. The majority of fines assessed were for money-laundering violations.

E. FINRA Plans to Provide Self-Reporting Guidance.

CEFLI staff reported that FINRA is drafting guidance to explain what types of cooperation may entitle broker-dealers to reduce sanctions when they self-report a violation.

The new guidance will update Regulatory Notice 08 – 70 which was issued in 2008.

V. CEFLI Activities.

A. Replacements Webinar - Wednesday, March 27.

CEFLI staff provided a brief report on the Replacements webinar held on Wednesday, March 27.

CEFLI member companies Allianz Life and Sagicor Life shared details about their replacement review processes, issues they have encountered in NY and other markets and strategies for encouraging compliance with replacement requirements when dealing with consumers, producers and other insurers.

Mark McLeod and Sharon Ma of the New York State Department of Financial Services discussed the types of replacements they are paying close attention to, recent exam findings involving replacements and answered many questions about Reg 60 compliance.

B. Compliance Fundamentals Training Conference - May 8-10 – Austin, Texas.

On May 8-10, CEFLI will be conducting its Compliance Fundamentals Training Conference at The Driskell Hotel in Austin, Texas.

CEFLI's Compliance Fundamentals Training Conference is available free of charge as part of your company's membership benefits. The Conference is designed to provide education and training for those who may be new to the life insurance industry or those who may be new to the compliance function within a life insurance company.

Registration for the Conference is available online via CEFLI's website. A copy of the preliminary program for the Conference is attached.

If you may be interested in serving as a faculty member at the Conference, please let us know. We are still completing the lineup of faculty members who will be presenting information at the Conference.

We hope to see you in Austin on May 8-10!

VI. Next Meeting.

The Committee will hold its next meeting on April 17, 2019 - 2 PM EDT/1 PM CDT/12 Noon MST/11 AM PDT.

The Committee will hold further 2019 meetings as follows:

May 15, 2019 - 2 PM EDT/1 PM CDT/12 Noon MST/11 AM PDT
June 11, 2019 - 2 PM EDT/1 PM CDT/12 Noon MST/11 AM PDT
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December 18, 2019 - 2 PM EST/1 PM CST/12 Noon MST/11 AM PST

Please mark your calendar and plan to join us!

VII. Other Business.

There being no further business to discuss, the meeting was adjourned.

Insurance Circular Letter No. 1 (2019)

January 18, 2019

TO: **All Insurers Authorized to Write Life Insurance in New York State**

RE: **Use of External Consumer Data and Information Sources in Underwriting for Life Insurance**

STATUTORY REFERENCES: Insurance Law § 4224; Insurance Law Articles 24 and 26; General Business Law Article 25 (Fair Credit Reporting Act); Executive Law Article 15 (Human Rights Law); and the Federal Civil Rights Act of 1964, Pub. L. No. 88-352, 78 Stat. 241 (codified as amended in scattered sections of 2 U.S.C., 28 U.S.C., and 42 U.S.C.).

I. Summary

The purpose of this circular letter is to advise insurers authorized to write life insurance in New York of their statutory obligations regarding the use of external consumer data and information sources in underwriting for life insurance.

II. Discussion

Following reports of the emergence of unconventional sources or types of external data available to insurers, including within algorithms and predictive models, the New York State Department of Financial Services ("Department") commenced an investigation of insurers' underwriting guidelines and practices in New York related to the use of external data in underwriting for life insurance.

For purposes of this Circular Letter, external data includes any data or information sources not directly related to the medical condition of the applicant that is used – in whole or in part – to supplement traditional medical underwriting, as a proxy for traditional medical underwriting, or to establish "lifestyle indicators" that may contribute to an underwriting assessment of an applicant for life insurance coverage. For the purposes of this Circular Letter, external data sources do not include an MIB Group, Inc. member information exchange service, a motor vehicle report, or a criminal history search[1].

The Department fully supports innovation and the use of technology to improve access to financial services. Indeed, insurers' use of external data sources has the potential to benefit insurers and consumers alike by simplifying and expediting life insurance sales and underwriting processes. External data sources also have the potential to result in more accurate underwriting and pricing of life insurance. At the same time, however, the accuracy and reliability of external data sources can vary greatly, and many external data sources are companies that are not subject to regulatory oversight and consumer protections, which raises significant concerns about the potential negative impact on consumers, insurers and the life insurance marketplace in New York.

This circular letter addresses two particular areas of immediate concern with the use of external data sources, algorithms or predictive models that were identified during the Department's investigation. First, the use of external data sources, algorithms, and predictive models has a significant potential negative impact on the availability and affordability of life insurance for protected classes of consumers. An insurer should not use an external data source, algorithm or predictive model for underwriting or rating purposes unless the insurer can establish that the data source does not use and is not based in any way on race, color, creed, national origin, status as a victim of domestic violence, past lawful travel, or sexual orientation in any manner, or any other protected class. Moreover, an insurer should also not use an external data source for underwriting or rating purposes unless the use of the external data source is not unfairly discriminatory and complies with all other requirements in the Insurance Law and Insurance Regulations. Second, the use of external data sources is often accompanied by a lack of transparency for consumers. Where an insurer is using external data sources or predictive models, the reason or reasons for any declination, limitation, rate differential or other adverse underwriting decision provided to the insured or potential insured should include details about all information upon which the insurer based such decision, including the specific source of the information upon which the insurer based its adverse underwriting decision.

It is important to note that this circular letter is not intended to provide an all-inclusive list of potential issues that could arise from the use of external data sources (including for both life and other kinds of insurance), nor is it intended to suggest that an insurer's due diligence in assessing an external data source should be limited to the above two concerns.

A. <u>Unlawful Discrimination</u>

The N.Y. Insurance Law, Executive Law, General Business Law, and federal Civil Rights Act, protect against discrimination for certain classes of individuals. These laws govern the activities of insurers, including the ability of insurers to underwrite based on certain criteria. For example, Insurance Law Article 26 prohibits the use of race, color, creed, national origin, status as a victim of domestic violence, or past lawful travel in any manner, among other things, in underwriting. In addition, Insurance Law §§ 4224(a)(2) and (b)(2) prohibit insurers from refusing to insure or continuing to insure, limiting the amount, extent or kind of coverage, or charging a different rate for the same coverage solely because of the physical or mental disability, impairment or disease, or prior history of the disability or disease of an insured or potential insured except where the refusal, limitation or rate differential is permitted by law or regulation and is based on sound actuarial principles or is related to actual or reasonably anticipated experience. Insurers are responsible for complying with these anti-discrimination laws irrespective of whether they themselves are collecting data and directly underwriting consumers, or relying on external data sources, algorithms of external vendors or predictive models that are intended to be partial or full substitutes for direct underwriting. In short, an insurer may not use an external data source to collect or use information that the insurer would otherwise be prohibited from collecting or using directly.

Based on its investigation, the Department has determined that insurers' use of external data sources in underwriting has the strong potential to mask the forms of discrimination prohibited by these laws. Many of these external data sources use geographical data (including community-level mortality, addiction or smoking data), homeownership data, credit information, educational attainment, licensures, civil judgments and court records, which all have the potential to reflect disguised and illegal race-based underwriting that violates Articles 26 and 42.

Other models and algorithms purport to make predictions about a consumer's health status based on the consumer's retail purchase history; social media, internet or mobile activity; geographic location tracking; the condition or type of an applicant's electronic devices (and any systems or applications operating thereon); or based on how the consumer appears in a photograph. At the very least, the use of these models may either lack a sufficient rationale or actuarial basis and may also have a strong potential to have a disparate impact on the protected classes identified in New York and federal law.

In light of the Department's investigation and findings, the Department is providing the following principles that insurers should use as guidance in using external data sources in underwriting.

First, an insurer should not use an external data source, algorithm or predictive model in underwriting or rating unless the insurer has determined that the external tools or data sources do not collect or utilize prohibited criteria. An insurer may not simply rely on a vendor's claim of non-discrimination or the proprietary nature of a third-party process as a justification for a failure to independently determine compliance with anti-discrimination laws. The burden remains with the insurer at all times.

Second, an insurer should not use an external data source, algorithm or predictive model in underwriting or rating unless the insurer can establish that the underwriting or rating guidelines are not unfairly discriminatory in violation of Articles 26 and 42. In evaluating whether an underwriting or rating guideline derived from external data sources or information is unfairly discriminatory, an insurer should consider the following questions:

(1) Is the underwriting or rating guideline that is derived, in whole or in part, from external data sources or information supported by generally accepted actuarial principles or actual or reasonably anticipated experience that justifies different results for similarly situated applicants?

(2) Is there a valid explanation or rationale for the differential treatment of similarly situated applicants reflected by the underwriting or rating guideline that is derived, in whole or in part, from external data sources or information?

Importantly, even if statistical data is interpreted to support an underwriting or rating guideline, there must still be a valid rationale or explanation supporting the differential treatment of otherwise like risks. The second part of this inquiry is particularly important where there is no demonstrable causal link between the classification and increased mortality and also where an underwriting or rating guideline has a disparate impact on protected classes.

Data, algorithms, and models that purport to predict health status based on a single or limited number of unconventional criteria also raise significant concerns about the validity of such models.

An insurer may establish guidelines and practices to assess an applicant's health status and identify individuals at higher mortality risk if based on sound actuarial principles or if related to actual or reasonably anticipated experience. However, the data, algorithms, and predictive modeling used by the insurer must comport with the principles set forth above and all other relevant requirements in federal and New York law. An insurer may not rely on external data or external predictive algorithms or models unless the insurer has determined that the external data or predictive model is otherwise permitted by law or regulation and is based on both sound actuarial principles or experience and a valid explanation or rationale.

B. Consumer Disclosure/Transparency

Transparency is an important consideration in the use of external data sources to underwrite life insurance. Pursuant to Insurance Law § 4224(a)(2), insurers must notify the insured or potential insured of the right to receive the specific reason or reasons for a declination, limitation, rate differential or other adverse underwriting decision. An adverse underwriting decision would include the inability of an applicant to utilize an expedited, accelerated or algorithmic underwriting process in lieu of a traditional medical underwriting. Where an insurer is using external data sources or predictive models, the reason or reasons provided to the insured or potential insured must include details about all information upon which the insurer based any declination, limitation, rate differential or other adverse underwriting decision, including the specific source of the information upon which the insurer based its adverse underwriting decision. An insurer may not rely on the proprietary nature of a third-party vendor's algorithmic processes to justify the lack of specificity related to an adverse underwriting action. Insurers must also provide notice to and obtain consent from consumers to access external data, where required by law or regulation. The failure to adequately disclose the material elements of an accelerated or algorithmic underwriting process, and the external data sources upon which it relies, to a consumer may constitute an unfair trade practice under Insurance Law Article 24.

III. Conclusion

The Department supports efforts to improve the effectiveness and timeliness of insurance underwriting decisions in order to provide consumers with increased access to financial services consistently with law. Accordingly, an insurer should not use external data sources, algorithms or predictive models in underwriting or rating unless the insurer has determined that the processes do not collect or utilize prohibited criteria and that the use of the external data sources, algorithms or predictive models are not unfairly discriminatory. The insurer must establish that the external data sources, algorithms or predictive models are based on sound actuarial principles with a valid explanation or rationale for any claimed correlation or causal connection.

An insurer must also disclose to consumers the content and source of any external data upon which the insurer has based an adverse underwriting decision.

The Department reserves the right to audit and examine an insurer's underwriting criteria, programs, algorithms, and models, including within the scope of regular market conduct examinations, and to take disciplinary action, including fines, revocation and suspension of license, and the withdrawal of product forms.

Please direct any questions regarding this circular letter to: Peter Dumar, Chief Insurance Attorney, Life Bureau, New York State Department of Financial Services, One Commerce Plaza, Albany, New York 12257 or by email at **peter.dumar@dfs.ny.gov**.

Sincerely,

James Regalbuto
Deputy Superintendent - Life Insurance

[1] Criminal history only includes past convictions or pending criminal matters. It does not include prior arrests, pleas or imprisonment for which an individual was not convicted of any crime; or civil dispute history such as appearances in housing court, civil litigation, liens, bankruptcy, etc. See Executive Law § 296(16). Criminal history does include being sanctioned by the U.S. Government (or any agency thereof), or by any international organization in which the U.S. Government (or any agency thereof) is a member, for money laundering, terrorism, trafficking, etc.

South Carolina Department of Insurance

Capitol Center
1201 Main Street, Suite 1000
Columbia, South Carolina 29201

Mailing Address:
P.O. Box 100105, Columbia, S.C. 29202-3105
Telephone: (803) 737-6160

HENRY McMASTER
Governor

RAYMOND G. FARMER
Director

BULLETIN NUMBER 2019-02

TO: Insurers Writing Life Insurance in South Carolina

FROM: Raymond G. Farmer
Director of Insurance

SUBJECT: Compliance with S.C. Code §38-63-220(d) Rescission of a Life Insurance Policy

DATE: April 3, 2019

I. PURPOSE

It has come to the attention of the South Carolina Department of Insurance (DOI) that there may be some life insurers who may be attempting to rescind life insurance policies in a unilateral manner inconsistent with the requirements of the South Carolina insurance laws. The purpose of this bulletin is to remind insurers who issue life insurance policies in the State of South Carolina that they are required to include and comply with the Required Provisions set forth in S.C. Code Ann. §38-63-220.

II. DISCUSSION

Life insurance policies issued in South Carolina must strictly adhere to the statutory provisions set forth in S.C. Code §38-63-220, specifically S.C. Code §38-63-220(d). This provision provides, in pertinent part, that policies must include:

> a provision that the policy and any rider or supplemental benefits attached to the policy are incontestable as to the truth of the application for insurance and to the representations of the insured individual after they have been in force during the lifetime of the insured for a period of two years from their date of issue. Any rider or supplemental benefits subsequently attached to the policy are incontestable as to the truth of the application for the rider or supplemental benefits and to the representations of the insured individual after they have been in force during the lifetime of the insured for a period of two years from their date of issue. ***If an insurer institutes proceedings to vacate a policy on the ground of the falsity of***

> ***the representations contained in the application for the policy, the proceedings must commence within the time permitted in this subsection;*** (emphasis added).

Thus, the South Carolina General Assembly mandated that if an insurer wanted to challenge the truthfulness of the application for insurance, it must do so during the first two years of the policy. After the policy has been in effect for two years, the application cannot be challenged on this basis. Section 38-63-220(d) has been interpreted as the authority to rescind a policy based upon false statements in an application discovered during the contestability period of the policy (i.e., the first two years of the policy). *See, e.g., Carroll v. Jackson National Life Insurance Company*, 307 S.C. 267, 414 S.E.2d 777 (1992) (insurer must challenge truthfulness of matters in the application during the first two years).

Based on the language of § 38-63-220(d), individual life insurance policies cannot be unilaterally rescinded. Section 38-63-220(d) provides a specific process for rescission (i.e., vacating) of the policy. According to the language in the statute, *any rescission of the life insurance policy within the two-year contestability period based upon alleged false representations contained in the insured's application must be accomplished through "**proceedings to vacate a policy**"* and must commence within the two-year timeframe set forth in the statute. (emphasis added). To vacate a policy means to cancel or declare it void. A letter or other notice to the insured stating that the policy has been canceled or rescinded does not qualify as a *proceeding to vacate a policy* under South Carolina law. A proceeding to vacate a policy is a judicial proceeding commenced to cancel the policy or have it declared null and void. Generally, the rescission issue may arise in an action brought by the insured on the policy, or in an action brought by the insurer to have the policy declared null and void. *See Insurer's Right to Rescind Insurance Contract for the Insured's False Statements*, 21 Am. Jur. POF 3d 565. Some insurers that have sought to rescind policies have done so through declaratory judgments and other civil actions.

Insurers are encouraged to confer with counsel about the type of proceeding necessary to vacate a life insurance policy in accordance with S.C. Code Ann. §38-63-220(d). Unilateral rescissions of life insurance policies violate South Carolina law. A violation of S.C. Code §38-63-220(d) may result in civil liability and/or disciplinary action initiated in accordance with S.C. Code Ann. § 38-2-10.

III. QUESTIONS

Any questions or concerns about this bulletin should be submitted in writing to the attention of:

David E. Belton
Senior Associate General Counsel
South Carolina Department of Insurance
1201 Main Street, Suite 1000
Columbia, SC 29202

Rule Proposal

Reporter
51 N.J.R. 493(a)
NJ - New Jersey Register > 2019 > APRIL > APRIL 15, 2019 > RULE PROPOSAL > LAW AND PUBLIC SAFETY -- DIVISION OF CONSUMER AFFAIRS

Interested Persons Statement

INTERESTED PERSONS
Interested persons may submit comments, information or arguments concerning any of the rule proposals in this issue until the date indicated in the proposal. Submissions and any inquiries about submissions should be addressed to the agency officer specified for a particular proposal.

The required minimum period for comment concerning a proposal is 30 days. A proposing agency may extend the 30-day comment period to accommodate public hearings or to elicit greater public response to a proposed new rule or amendment. Most notices of proposal include a 60-day comment period, in order to qualify the notice for an exception to the rulemaking calendar requirements of N.J.S.A. 52:14B-3. An extended comment deadline will be noted in the heading of a proposal or appear in a subsequent notice in the Register.

At the close of the period for comments, the proposing agency may thereafter adopt a proposal, without change, or with changes not in violation of the rulemaking procedures at N.J.A.C. 1:30-6.3. The adoption becomes effective upon publication in the Register of a notice of adoption, unless otherwise indicated in the adoption notice. Promulgation in the New Jersey Register establishes a new or amended rule as an official part of the New Jersey Administrative Code.
Agency

LAW AND PUBLIC SAFETY > DIVISION OF CONSUMER AFFAIRS > BUREAU OF SECURITIES

Administrative Code Citation

Proposed Amendment: N.J.A.C. 13:47A-6.3

Proposed New Rule: N.J.A.C. 13:47A-6.4
Text

Fiduciary Duty of Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives

Authorized By: Christopher W. Gerold, Bureau Chief, Bureau of Securities.
Authority: N.J.S.A. 49:3-67(a).

Calendar Reference: See Summary below for explanation of exception to calendar requirement.

Proposal Number: **PRN 2019-044**.

Submit written comments by **June 14, 2019**, to:

Christopher W. Gerold, Bureau Chief
Bureau of Securities
153 Halsey Street, 6th Floor
PO Box 47029
Newark, New Jersey 07101

or electronically at: http://www.njconsumeraffairs.gov/proposals/pages/default.aspx

The agency proposal follows:

Summary

In order to better protect the public interest and, in particular, New Jersey's investing public, the New Jersey Bureau of Securities (Bureau) is proposing new N.J.A.C. 13:47A-6.4 to establish, by regulation, the common law fiduciary duty and apply it to broker-dealers and agents, and to codify it for investment advisers and investment adviser representatives. The Bureau believes that the proposed new rule is necessary to ensure that persons involved in the securities markets are uniformly held to a high standard in their dealings with the general public and is necessary to ensure the welfare of New Jersey investors. Moreover, the proposed new rule will establish a uniform standard for financial professionals and rectify investor confusion that results from the lack of uniformity.

The Bureau published a notice of pre-proposal soliciting comments regarding amendments to its rules to require that broker-dealers, agents, investment advisers, and investment adviser representatives owe a fiduciary duty to their customers. In addition, in connection with the notice of pre-proposal, the Bureau held two informal conferences to take testimony from interested parties to gather facts to inform a rulemaking and to afford ample opportunity for the receipt of public comment from the regulated communities, industry representatives, and the public at large. The notice of pre-proposal and informal conferences was published in the New Jersey Register on October 15, 2018, at 50 N.J.R. 2142(a). The Bureau received 62 comments and there were 21 speakers at the informal conferences.

It is well established that investment advisers owe their customers a fiduciary duty as a matter of law. Broker-dealers by rule are subject to a suitability standard, which means having reasonable grounds to believe that the strategy, transaction, or recommendation is suitable for the customer, based upon reasonable inquiry concerning the customers' investment objectives, financial situation, and needs, and any other relevant information known by the broker-dealer.

In the wake of the 2008 financial crisis, Congress recognized the need to ensure that retail investors can readily access unbiased advice from all financial professionals, regardless of whether that advice comes from an investment adviser or broker-dealer. In accordance with Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Securities and Exchange Commission (SEC) conducted a study (the 913 Study) and the SEC staff recommended that the SEC establish a uniform fiduciary duty standard for investment advisers and broker-dealers when providing investment advice about securities to retail customers that is consistent with the standard that currently applies to investment advisers.

An investment adviser is a fiduciary whose duty is to serve the best interests of its clients, including an obligation not to subordinate clients' interests to its own. Included in the fiduciary standard are the duties of loyalty and care. An investment adviser that has a material conflict of interest must either eliminate that conflict or fully disclose to its clients all material facts relating to the conflict.

Broker-dealers that do business with the public generally must become members of the Financial Industry Regulatory Authority (FINRA), which serves as a self-regulatory organization (SRO) for broker-dealers. Under the antifraud provisions of the Federal securities laws and SRO rules, including SRO rules relating to just and equitable principles of trade and high standards of commercial honor, broker-dealers are required to deal fairly with their customers. Moreover, broker-dealers are subject to statutory, SEC, and SRO requirements that are designed to promote business conduct that protects customers from abusive practices, including practices that may be unethical but may not necessarily be fraudulent. Currently, broker-dealers and their agents are required to have a reasonable basis to believe a recommended transaction or investment strategy involving securities is suitable for the customer. The reasonable basis is based on information obtained through reasonable diligence of the broker-dealer or agent to ascertain the customer's investment profile. FINRA Rule 2111 states the customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, and risk tolerance.

[page=494] The 913 Study reflected that retail investors do not understand the differences between investment advisers and broker-dealers or the standards of care applicable to broker-dealers and investment advisers. Many find the different standards of care confusing and are uncertain about the meaning of the various titles and designations, such as "money-manager," "wealth-manager," "financial advisor," etc., used by investment advisers and broker-dealers. Many expect that both investment advisers and broker-dealers are obligated to act in the investors' best interests. Moreover, many retail investors expect, and incorrectly believe, that financial professionals, including broker-dealers, are acting in a fiduciary type relationship of trust. In addition, because many broker-dealers are also investment advisers, this compounds the problem of investor confusion. These dual registrants "switch hats" when dealing with the same customers, thereby blurring the lines between investment advisory services and sales services.

The need for additional protection for investors is highlighted by the March, 2018 Federal appeals court decision vacating the Department of Labor's Fiduciary Rule (DOL Fiduciary Rule), and the April, 2018 SEC proposal of Regulation Best Interest, in response to the 913 Study. The Department of Labor, under its authority to promulgate rules under the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. §§ 1001 et seq., and 26 U.S.C. § 4975, sought among other things, to update the definition of investment-advice fiduciary (first promulgated in 1975) to provide additional protections for employee benefit plans, and their participants and beneficiaries. The Department of Labor's initiative considered the dramatic changes in retirement plans and accounts since ERISA's enactment, notably the shift from pension plans controlled by large employers and money managers to individual retirement accounts (IRAs) and retirement plans directed by participants, such as 401(k)s. The DOL Fiduciary Rule brought under its umbrella those financial and insurance professionals who do business with ERISA plans and IRA holders, including those who did not provide advice on a "regular" basis. While the rule survived initial challenges, the United States Court of Appeals for the Fifth Circuit reversed the district court for Northern Texas and vacated the rule, holding, among other things, that the Department of Labor acted beyond its express statutory authority in crafting its rule by expanding the definition of investment-advice fiduciary.

The SEC's response to the 913 Study similarly compels the Bureau to take action to protect New Jersey investors. Several commenters to the pre-proposal requested that the Bureau not proceed with its rulemaking until the SEC adopts the "Regulation Best Interest," which requires all broker-dealers and agents to act in the best interest of retail customers when making a recommendation of any securities transaction or investment strategy involving securities to retail customers. The Bureau has been monitoring and reviewing the SEC's rulemaking process, including the comments submitted to the SEC. As several commenters to the pre-proposal noted, the proposed SEC standard is greater than that of the suitability rule but is less than that of a fiduciary duty. The Bureau believes that the SEC Regulation Best Interest does not provide sufficient protections for New Jersey investors. The Bureau believes that imposing a fiduciary duty standard for broker-dealers, investment advisers, agents, and investment adviser representatives protects investors against the abuses that can result when financial professionals place their own interests above those of their customers, will help to reduce investor confusion, and will work to foster public confidence in the financial profession. Accordingly, the Bureau determined to proceed with this rulemaking at this time.

The Bureau proposes to amend the Bureau's existing suitability standard for broker-dealers and agents at N.J.A.C. 13:47A-6.3(a)3 to add an exception for when the fiduciary duty proposed at N.J.A.C. 13:47A-6.4 applies. In addition, the Bureau proposes to amend the rule to include recommendations for the "opening of or transfer of assets to any type of account," which is commonly understood to be encompassed as part of an investment strategy.

Proposed new N.J.A.C. 13:47A-6.4 establishes as a dishonest or unethical business practice, failing to act in accordance with a fiduciary duty to a customer when providing investment advice or recommending to a customer an investment strategy, the opening of or transfer of assets to any type of account, or the purchase, sale, or exchange of any security. In accordance with the common law definition of fiduciary duty, both the duty of care and duty of loyalty must be satisfied. The rule sets forth to whom the duty is owed and the duration for which the duty is owed. In addition, the rule allows for transaction-based fees if certain conditions are met. The Bureau notes that, in accordance with the subchapter definitions as set forth at N.J.A.C. 13:47A-6.2, when the Bureau refers to "adviser" at N.J.A.C. 13:47A-6.4 the term "adviser" includes both investment adviser as defined in N.J.S.A. 49:3-49(g) and investment adviser representative as defined in N.J.S.A. 49:3-49(s).

Proposed new N.J.A.C. 13:47A-6.4(a)1 specifies that for a broker-dealer, or its agent, failing to act in accordance with a fiduciary duty to a customer when making a recommendation or providing investment advice is a dishonest or unethical business practice. As set forth in subsection (a), a recommendation includes one for an investment strategy, the opening of or transfer of assets to any type of account, or the purchase, sale, or exchange of any security. Subparagraph (a)1i states that when making a recommendation, the fiduciary duty obligation extends through the execution of the recommendation and shall not be deemed an ongoing obligation. To address the concerns over dual registrants "switching hats" when dealing with the same customer and the resulting investor confusion, the Bureau proposes subparagraph (a)1ii, to state that if a broker-dealer or agent also provides, in any capacity, investment advice to the customer, the fiduciary duty obligation is an ongoing obligation to that customer. The fiduciary duty will be applicable to the entire relationship with the customer, regardless of the security account type. Paragraph (a)2 provides that it is a dishonest or unethical business practice if an adviser, or a broker-dealer or its agent who has discretionary authority over the customer's account or a contractual fiduciary duty, or who is acting as an adviser, fails to act in accordance with a fiduciary duty to a customer when providing investment advice.

Proposed new N.J.A.C. 13:47A-6.4(b) provides that, to meet the fiduciary duty, a broker-dealer, agent, or adviser shall satisfy both the duty of care and duty of loyalty. Paragraph (b)1 sets forth the common law duty of care. Subparagraph (b)1i specifies that, for purposes of the duty of care, the broker-dealer, agent, or adviser must make reasonable inquiry, including risks, costs, and conflicts of interest related to the recommendation or investment advice, and the customer's investment objectives, financial situation, and needs, and any other relevant information. Paragraph (b)2 sets forth the common law duty of loyalty, such that the recommendation or the advice is made without regard to the financial or any other interest of the broker-dealer, agent, adviser, any affiliated or related entity and its officers, directors, agents, employees, or contractors, or any other third-party. The Bureau is concerned about harmful incentives, such as sales contests, that encourage and reward conflicted advice. Accordingly, subparagraph (b)2i establishes a presumption of a breach of the duty of loyalty for offering or receiving direct or indirect compensation to or from the broker-dealer, its agent, or adviser for recommending the opening of or transfer of assets to a specific type of account, or the purchase, sale, or exchange of a specific security that is not the best of the reasonably available options. The Bureau also proposes new subparagraph (b)2ii to specify that there is no presumption that disclosing a conflict of interest in and of itself will satisfy the duty of loyalty. In its testimony before the SEC's Investor Advisory Committee meeting on the proposed Regulation Best Interest and Customer Relationship Summary Form, the AARP noted: "Recent behavioral science studies have shown that disclosures are largely ineffective because they tend to increase conflict in advisers and make the investor more likely to trust the adviser and thus follow biased advice. [(citing Sunita Sah, Gray Matter: The Paradox of Disclosure, NEW YORK TIMES, July 8, 2016; Sunita Sah and George Loewenstein, Nothing to Declare: Mandatory and Voluntary Disclosure Leads Advisors to Avoid Conflicts of Interest, 25(2) PSYCHOL. SCI. 575-584 (2014); cf. Sunita Sah, Angela Fagerlin, and Peter Ubel, Effect of physician disclosure of specialty bias on patient trust and treatment choice,http://www.pnas.org/content/113/27/7465.full.pdf.)] Indeed, simply disclosing conflicts does not provide adequate protection and does not shield investors from potential financial harm of conflicted advice. Disclosure may even have unintended effects, such as making a consumer more confident that a financial professional is meeting a higher standard than he or she actually may be meeting."

[page=495] Proposed N.J.A.C. 13:47A-6.4(b)3 allows, notwithstanding the presumption set forth at subparagraph (b)2i, for a broker-dealer or agent to receive a transaction-based fee provided that the fee is reasonable and is the best of the reasonably available fee options for the customer, and the duty of care is satisfied. The requirement that the fee is reasonable, is consistent with existing Bureau rule, N.J.A.C. 13:47A-6.3(a)12, which sets forth as a dishonest or unethical business practice, charging unreasonable and inequitable fees for services performed.

Proposed new subsection (c) sets forth the individuals and entities that are excluded from being deemed a "customer." For purposes of N.J.A.C. 13:47A-6.4 a customer would not include: a bank, savings and loan association, insurance company, or registered investment company; a broker-dealer registered with a state securities commission (or agency or office performing like function); an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or agency or office performing like function); or any other person (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $ 50 million.

New N.J.A.C. 13:47A-6.4(d) provides that the provisions at N.J.A.C. 13:47A-6.4 do not apply to a person acting in the capacity of a fiduciary to an Employee Benefit Plan, its participants, or beneficiaries, as those terms are defined in ERISA, 29 U.S.C. §§ 1001 et seq.

New N.J.A.C. 13:47A-6.4(e) states that nothing in N.J.A.C. 13:47A-6.4 shall be construed to establish any capital, custody, margin, financial responsibility, making and keeping of records, bonding, or financial or operation reporting requirements for any broker-dealer or agent of any broker-dealer that differ from, or are in addition to, the requirements established under 15 U.S.C. § 78o(i).

To allow broker-dealers, their agents, or advisers time to implement the Bureau's new rule, the Bureau is proposing at N.J.A.C. 13:47A-6.4(f) that the operative date for the new rule to be 90 days after the effective date of the rulemaking.

As the Bureau has provided a 60-day comment period on this notice of proposal, this notice is exempted from the rulemaking calendar requirement pursuant to N.J.A.C. 1:30-3.3(a)5.

Social Impact

The Bureau believes that proposed new rule N.J.A.C. 13:47A-6.4 will have a positive social impact upon the public by increasing confidence in financial professionals and ensuring that investors are protected against the abuses that can result when financial professionals place their own interests above those of their customers, regardless if investing with a broker-dealer or an investment adviser.

The Bureau also believes that the proposed amendment and new rule will have a positive effect upon members of the regulated community by clarifying their obligations and responsibilities under the State securities laws.

Economic Impact

The Bureau believes that the proposed amendment to N.J.A.C. 13:47A-6.3(a) will not have any economic impact because it is providing further guidance concerning the existing suitability standard.

Proposed new N.J.A.C. 13:47A-6.4 may have an economic impact on broker-dealers and may indirectly impact broker dealer agents, investment advisers, and investors. The Bureau believes that any increased costs are outweighed by the interest in protecting the welfare of investors.

To the extent broker-dealers choose to modify written policies and procedures or provide training to their employees, the proposed new rule will have an economic impact upon broker-dealers. The costs will vary depending upon a firm's existing business practices with respect to disclosure and conflict mitigation activities to comply with existing requirements. In addition, to the extent that broker-dealers are currently able to generate revenues from securities recommendations that are consistent with FINRA's suitability rule but are not consistent with the proposed fiduciary duty standard, those revenues would be impacted. The proposed new rule may require broker-dealers to engage the professional services of attorneys to ensure they comply with the proposed new rule. The costs associated with engaging professional services of attorneys are difficult to estimate, and they will vary depending upon the amount of work that each registrant will require and the rate that the professional will collect for his or her services.

To the extent the proposed new rule impacts financial incentives or bonus programs for financial professionals to recommend proprietary products and services over third-party or non-proprietary products, or the types of accounts in which they enroll their customers, may impact broker-dealer agents' financial compensation. The impact is difficult to estimate because the amount of financial professionals' compensation varies and there are different compensation models.

The Bureau notes that in April 2016, the Department of Labor adopted a fiduciary rule in connection with services for retirement accounts. Although in March 2018, the DOL Fiduciary Rule was vacated by the United States Court of Appeals for the Fifth Circuit, a July 2017 survey of broker-dealers reflected that to comply with the DOL Fiduciary Rule many of the survey participants had already implemented changes to both retirement and non-retirement accounts. Accordingly, to the extent broker-dealers have already implemented changes to comply with the now vacated DOL Fiduciary Rule, the economic impact associated with the Bureau's proposed new rule will be reduced.

The Bureau also believes that the proposed new rule may have an indirect economic impact on investment advisers to the extent the proposed new rule impacts the competitive market for the provision of investment advice.

The proposed new rule may also have an indirect economic impact on investors to the extent broker-dealers determine they no longer wish to make certain recommendations and choose to forgo some of the revenue stream associated with such recommendations. Broker-dealers, for compliance or business reasons, may determine to avoid certain products or account types, despite the fact that those products or account types may be beneficial to certain customers in certain circumstances. In addition, the proposed new rule may decrease incentives of agents to expend effort in researching products or account types and, therefore, may impose a cost on customers if there is a decline in the quality or variety of recommendations.

In at least one study published in the Journal of Financial Planning, "The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice" by Michael Finke, Ph.D., CFP, and Thomas P. Langdon, J.D., LL.M., CFP, CFA, the study's authors explored the proposed application of a universal fiduciary standard and the impact on the financial adviser industry. The study surveyed registered representatives of broker-dealers in states that impose a fiduciary duty on the provision of investment advice to retail investors, and in states that do not impose such a duty. The authors concluded the following: "Empirical results provide no evidence that the broker-dealer industry is affected significantly by the imposition of a stricter legal fiduciary standard on the conduct of registered representatives. The opposition of the industry to the application of stricter regulation suggests that agency costs that exist when brokers are regulated according to suitability are significant. Imposition of a universal fiduciary standard among financial advisers may result in a net welfare gain to society, and in particular to consumers who are ill-equipped to reduce agency costs on their own by more closely monitoring an adviser with superior information, although this will likely occur at the expense of the broker-dealer industry. These results provide evidence that the industry is likely to operate after the imposition of fiduciary regulation in much the same way it did prior to the proposed change in market conduct standards that currently exist for brokers."

The Bureau believes that the proposed new rule may also have a positive economic impact on customers. According to a 2015 analysis by the United States Economic Council of Advisers, conflicted advice costs Americans about $ 17 billion in foregone retirement earnings each year. The analysis also stated that the prevalence of conflicted payments may actually interfere with low-balance savers' ability to get advice. The analysis noted that ongoing developments in the financial industry are sharply reducing the cost of advice, but it may be difficult for new entrants providing quality, unconflicted, low-cost advice to compete on price when other advice erroneously appears to be free. The analysis further states that, therefore the prevalence of hidden fees and conflicted payments may make it more difficult for low-cost, high-quality alternatives to compete on a level playing field, reducing moderate-income Americans' available options for inexpensive advice. In addition, as a result of the competitive [page=496] nature of the industry, to retain business, firms may lower the costs to clients. The Bureau also believes that investors may save money in terms of investment choices. Under a fiduciary duty, broker-dealers will now have to offer the lower-cost, similar investment option, which will potentially generate savings for investors.

The Bureau believes that any increased costs to broker-dealers, agents, investment advisers, investment adviser representatives, or to investors, are outweighed by the interest in protecting the welfare of investors and instilling greater confidence in the industry.

Federal Standards Analysis

With respect to investment advisers and investment adviser representatives, proposed new N.J.A.C. 13:47A-6.4 does not exceed Federal standards. The proposed new rule will exceed generally understood Federal standards with respect to broker-dealers and agents. The Bureau believes that this heightened standard is necessary to ensure the protection of New Jersey investors.

Although FINRA is not a government entity, it is subject to Federal oversight by the SEC, which reviews and approves all of FINRA's rules. As such, FINRA's suitability rules for broker-dealers and agents may be viewed as imposing a Federal standard.

In addition, the SEC is currently engaged in Regulation Best Interest rulemaking to require all broker-dealers and agents to act in the best interest of retail customers when making a recommendation of any securities transaction or investment strategy involving securities to retail customers. As several commenters have noted in their comments to the SEC's proposed Regulation Best Interest, this standard is purportedly greater than that of the suitability rule but is less than that of a fiduciary duty. Accordingly, should the SEC adopt Regulation Best Interest, the Bureau's proposed new rule will exceed this standard.

The Bureau believes that the proposed new rule is necessary to ensure that persons involved in the securities markets are held to a uniformly high standard in their dealings with the general public and are necessary to ensure the welfare of New Jersey investors.

Jobs Impact

The Bureau does not believe that the proposed amendment and new rule will result in the creation or the loss of jobs in the State.

Agriculture Industry Impact

The Bureau does not believe that the proposed amendment and new rule will have any impact on the agriculture industry of the State.

Regulatory Flexibility Analysis

As of January 1, 2019, there were approximately 2,050 broker-dealers, 200,800 agents, 3,230 investment advisers, and 29,730 investment adviser representatives registered with the Bureau. If such registrants are considered "small businesses" within the meaning of the Regulatory Flexibility Act, N.J.S.A. 52:14B-16 et seq., then the following analysis applies.

The proposed amendment at N.J.A.C. 13:47A-6.3(a)3 does not impose any new compliance requirement as it is codifying the generally understood suitability standard. Proposed new rule N.J.A.C. 13:47A-6.4 imposes new compliance requirements, which are discussed in the Summary above. The proposed amendment and new rule do not impose any new recordkeeping or reporting requirements. The costs associated with the proposed amendment and new rule are discussed in the Economic Impact statement. The proposed new rule may require registrants to engage the professional services of attorneys to ensure they comply with the proposed new rule. The costs associated with engaging professional services of attorneys are difficult to estimate, and they will vary depending upon the amount of work that each registrant will require and the rate that the professional will collect for his or her services.

The Bureau is proposing the amendments and new rule to protect the welfare of the investing public. The rules will apply to all members of the regulated community. Therefore, no differing compliance requirements for any registrant is provided based upon the size of the business.

Housing Affordability Impact Analysis

The proposed amendment and new rule will have an insignificant impact on the affordability of housing in New Jersey and there is an extreme unlikelihood that the amendment and new rule would evoke a change in the average costs associated with housing because the rules concern the dishonest or unethical business practices of State registered securities professionals.

Smart Growth Development Impact Analysis

The proposed amendment and new rule will have an insignificant impact on smart growth and there is an extreme unlikelihood that the amendment and new rule would evoke a change in housing production in Planning Areas 1 or 2, or within designated centers, under the State Development and Redevelopment Plan in New Jersey because the rules concern the dishonest or unethical business practices of State registered securities professionals.

Racial and Ethnic Community Criminal Justice and Public Safety Impact

The Bureau has evaluated this rulemaking and determined that it will not have an impact on pretrial detention, sentencing, probation, or parole policies concerning adults and juveniles in the State. Accordingly, no further analysis is required.

Regulations

Full text of the proposal follows (additions indicated in boldface **thus**; deletions indicated in brackets [thus]):

SUBCHAPTER 6. DISHONEST OR UNETHICAL BUSINESS PRACTICES

13:47A-6.3 Examples of dishonest or unethical practices for broker-dealers, agents, issuer-agents, advisers, and internet site operators

(a) "Dishonest or unethical practices" as used in N.J.S.A. 49:3-47 et seq., specifically in N.J.S.A. 49:3-53(a)(3) and 49:3-58(a)(2)(vii), shall include the following:

1.-2. (No change.)
3. [Recommending] **Except as provided at N.J.A.C. 13:47A-6.4, recommending** to a customer**,** an investment strategy, **the opening of, or transfer of assets to, any type of account,** or the purchase, sale, or exchange of any security or securities without reasonable grounds to believe that such strategy, transaction, or recommendation is suitable for the customer based upon reasonable inquiry concerning the customer's investment objectives, financial situation, and needs, and any other relevant information known by the broker-dealer;

4.-64. (No change.)

13:47A-6.4 Fiduciary duty of broker-dealers, agents, and advisers

(a) "Dishonest or unethical business practices" as used at N.J.S.A. 49:3-47 et seq., specifically at N.J.S.A. 49:3-53(a)(3) and49:3-58(a)(2)(vii), shall include providing investment advice orrecommendingto a customer, an investment strategy, the opening of, or transfer of assets to, any type of account, or the purchase, sale, or exchange of any security when:

1.A broker-dealer, or its agent, fails to act in accordance with a fiduciary duty to a customer when making a recommendation or providing investment advice.

i. When making a recommendation, the fiduciary duty required in (a)1 above shall extend through the execution of the recommendation and shall not be deemed an ongoing obligation, except as provided in (a)2 below.

ii. If a broker-dealer or agent also provides, in any capacity, investment advice to the customer, the fiduciary duty shall be deemed an ongoing obligation to that customer.

2. An adviser, or a broker-dealer or its agent who is acting as an adviser, has discretionary authority over a customer's account or a contractual fiduciary duty, fails to act in accordance with a fiduciary duty to a customer when providing investment advice.

(b) To meet the fiduciary duty, a broker-dealer, agent, or adviser shall satisfy both the duty of care and duty of loyalty.

1. When making a recommendation or providing investment advice, the duty of care requires a broker-dealer, agent, or adviser to use the care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use taking into consideration all of the facts and circumstances.

[page=497] **i. For purposes of this paragraph, a broker-dealer, agent, or adviser shall make reasonable inquiry, including risks, costs, and conflicts of interest related to the recommendation or investment advice, and the customer's investment objectives, financial situation, and needs, and any other relevant information.**

2. When making a recommendation or providing investment advice, the duty of loyalty requires that a recommendation or the advice is made without regard to the financial or any other interest of the broker-dealer, agent, adviser, any affiliated or related entity and its officers, directors, agents, employees, or contractors, or any other third-party.

i. There shall be a presumption of a breach of the duty of loyalty for offering, or receiving, direct or indirect compensation to or from the broker-dealer, its agent, or adviser for recommending the opening of, or transfer of assets to a specific type of account, or the

purchase, sale, or exchange of a specific security that is not the best of the reasonably available options.

ii. There shall not be a presumption that disclosing a conflict of interest in and of itself shall satisfy the duty of loyalty.

3. Notwithstanding the presumption set forth at (b)2i above, it shall not be deemed a breach of the fiduciary duty owed to a customer when the broker-dealer or agent receives a transaction-based fee, provided that the fee is reasonable and is the best of the reasonably available fee options and the duty of care is satisfied.

(c) For purposes of this section, a "customer" shall not include:

1. A bank, savings and loan association, insurance company, or registered investment company;

2. A broker-dealer registered with a state securities commission (or agency or office performing like function);

3. An investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or agency or office performing like function); or

4. Any other person (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $ 50 million.

(d) Nothing in this section shall be construed to apply to a person acting in the capacity of a fiduciary to an employee benefit plan, its participants or beneficiaries, as those terms are defined in the Employee Retirement Income Security Act (ERISA), 29 U.S.C. §§ 1001 et seq.

(e) Nothing in this section shall be construed to establish any capital, custody, margin, financial responsibility, making and keeping of records, bonding, or financial or operation reporting requirements for any broker-dealer or agent of any broker-dealer that differ from, or are in addition to, the requirements established under 15 U.S.C. § 78o(i).

(f) The provisions of this section shall take effect on (90 days from the effective date of this new rule).