

**Agenda**

**CEFLI Regulatory Forum Meeting  
Tuesday, October 6, 2020  
1:00 PM-3:30 PM EDT  
Via CiscoWebEx**

**Link:**

**<https://cefli.webex.com/cefli/onstage/g.php?MTID=e8296a03be026f0f047a860c383e5b811>**

**Event number (access code): 132 232 5070**

**Event password: ethics2020#1**

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| <b>I. Welcome and Introduction.</b>   | <b>Donald J. Walters</b>            |
| <b>II. Antitrust Statement.</b>   | <b>Donald J. Walters</b>            |
| <b>III. Review of Transition from Advisory Committee to Regulatory Forum.</b> | <b>Donald J. Walters</b>            |
| <b>IV. Approval of Minutes – January 23, 2020 Advisory Committee Meeting</b>  | <b>Regulatory Forum</b>             |
| <b>V. Regulator Interview.</b>  | <b>Carrie O’Brien<br/>OCIE, SEC</b> |

We are pleased to have Carrie O’Brien, who serves as an Attorney within the Chief Counsel’s Office of the SEC’s Office of Compliance Inspections and Examinations (OCIE), join us for our Regulatory Forum meeting to discuss the SEC’s plans to conduct examinations to confirm compliance with the **SEC’s Regulation Best Interest and Form CRS**.

**VI. Overview and Discussion of Current Regulatory Issues. Regulatory Forum**

**A. Regulatory Activities in a COVID-19 Environment.**

**1. State Insurance Departments.**

The COVID-19 pandemic has presented unique challenges for life insurance companies and their regulators.

Recent data compiled by CEFLI as part of its 2020 Compliance & Ethics Benchmarking Survey indicates that life insurance companies have seen an increase in overall market regulation activity over the past several months with an increase in requests for data calls as part of state insurance department market analysis regulatory practices.

The COVID-19 environment may find a heightened dependence upon regulatory methods that do not require personal interaction in order to achieve regulatory oversight goals.

***Members of the Regulatory Forum will be asked to comment upon their observations concerning the increased use of data calls and other socially distanced methods to conduct regulatory oversight of life insurance companies by state insurance departments.***

2. Supervision in a Remote Work Environment.

Earlier this year, FINRA issued Regulatory Notice 20-16 to share practices implemented by firms to supervise practices in a remote work environment. (See copy attached.)

In addition to relying upon existing methods of supervision, some organizations instituted additional measures to enhance their supervisory practices in a remote work environment. Some measures identified included:

- Scheduling daily or weekly meetings to identify emerging risk issues relative to remote work;
- Establishing open “chat rooms” for supervisors to discuss remote work environment concerns;
- Sending reminders about ongoing regulatory responsibilities and affable policies and procedures; and
- Creating new electronic supervisory checklists.

***Members of the Regulatory Forum will be asked to comment upon their observations concerning supervisory practices in a remote work environment and the extent to which companies may have instituted enhanced or additional supervisory measures to address the challenges of a remote work environment.***

B. Revised NAIC Suitability in Annuity Transactions Model Regulation.

1. State Adoption Activity.

The NAIC recently adopted revisions to its NAIC Suitability in Annuity Transactions Model Regulation to incorporate a best interest standard to conform with the requirements of the SEC's Regulation Best Interest.

The revised Model Regulation has been adopted/enacted in Iowa and Arizona and has been introduced in several other states including Alabama, Arkansas, Delaware, Idaho, Kansas, Kentucky, Massachusetts, Michigan, North Dakota, Nevada, Ohio, Rhode Island, Tennessee and Texas.

***Members of the Regulatory Forum will be asked to share their perspectives on plans for various states to adopt the revised version of the NAIC Suitability in Annuity Transactions Model Regulation in their jurisdictions.***

2. Frequently Asked Questions - Revised NAIC Suitability in Annuity Transactions Model Regulation.

The NAIC recently issued Frequently Asked Questions designed to assist in uniform adoptions of the revised NAIC Suitability in Annuity Transactions Model Regulation across all jurisdictions. (See copy attached.)

The Frequently Asked Questions document seeks to provide interpretive guidance for states regarding the implementation and enforcement of the revised Model Regulation's requirements.

***Members of the Regulatory Forum will be asked to discuss the purpose of the Frequently Asked Questions document and the extent to which it is being used by states to assist in uniform adoptions of the revised Model Regulation.***

3. Life Insurance Company Compliance Strategies.

Whenever the NAIC adopts a Model Law or Regulation or modifies an existing Model Law or Regulation, life insurance companies must determine the strategies their organizations will use to comply with new requirements either on a nationwide or state-by-state basis as states adopt a new version of a Model Law or Regulation.

The recent revisions to the NAIC Suitability in Annuity Transactions Model Regulation present a unique challenge for life insurance companies to develop appropriate strategies to accommodate the various state adoptions of the revisions to the Model Regulation.

In some cases, life insurance companies will choose to implement the best interest standard embodied within the revised Model Regulation on a nationwide basis (regardless of whether all states have adopted the revised version of the Model Regulation). In other cases, life insurance companies will monitor state-by-state adoptions of the revised Model Regulation and will choose to implement compliance strategies in a state-by-state basis.

***Members of the Regulatory Forum will be asked to discuss their plans to monitor and implement appropriate compliance strategies in light of evolving adoptions of the revised Model Regulation by various states.***

C. FINRA Branch Office Inspections.

FINRA Rule 3110 requires member firms to supervise the activities of their associated persons and to conduct on-site inspections of all branch offices in other business locations.

In light of the COVID-19 pandemic, firms have found it difficult to conduct these on-site inspections in person and, therefore, have conducted branch office inspections virtually.

Given these operational challenges, FINRA has extended the time by which member firms must complete their calendar year 2020 inspection obligations to March 31, 2021.

***Members of the Regulatory Forum will discuss the challenges associated with conducting branch office inspections virtually and also will discuss FINRA's extension of time until March 31, 2021 to complete their branch office inspection requirements under FINRA Rule 3110.***

D. NASAA Report - Regulation Best Interest - DOL Fiduciary Rule.

The North American Securities Administrators Association (NASAA) recently released a report concerning a national examination initiative undertaken to determine broker-dealer and investment advisor policies, procedures and practices that existed prior to the adoption of the SEC's Regulation Best Interest to serve as a benchmark to measure the effectiveness of the SEC's Regulation Best Interest. (See copy attached.)

Recent media reports indicate that NASAA leadership has used the report to suggest that the US Department of Labor should defer its fiduciary rule until “it has proof that it would work to protect investors.” To that end, NASAA leadership indicated in recent testimony before the US Department of Labor that Regulation Best Interest, upon which the DOL fiduciary rule is based, “will not prevent conflicts of interest shown to harm workers and retirees.”

NASAA reportedly plans to conduct a second phase of their examination initiative in 2021 to evaluate changes in industry practices as firms comply with the requirements of Regulation Best Interest.

***Members of the Regulatory Forum will be asked to discuss the NASAA report and whether its initial findings may delay adoption of the proposed DOL fiduciary rule.***

E. NAIC Artificial Intelligence Principles.

The NAIC Artificial Intelligence (EX) Working Group recently adopted principles concerning the use of artificial intelligence in insurance. (See copy attached.)

This initiative was driven, in part, by the publication of artificial intelligence principles developed by the Organization for Economic Cooperation and Development (OECD) in Europe.

State insurance regulators acknowledge that insurers are increasingly using artificial intelligence methods to assist in a variety of life insurance company activities including underwriting, marketing and sale of life insurance and annuity products.

The NAIC Artificial Intelligence Principles were developed to provide expectations to guide insurance companies in the ethical and appropriate use of artificial intelligence.

***Members of the Regulatory Forum will be asked to discuss potential regulatory concerns regarding the use of artificial intelligence by insurance companies.***

F. Senior Financial Exploitation.

Concerns continue to exist with respect to the financial exploitation of seniors. Increasingly, life insurance companies have been dedicating distinct operational units to address suspected instances of senior financial exploitation.

To date, 30 states have enacted legislation to protect seniors and vulnerable investors from financial exploitation. These statutes provide financial services firms with civil and administrative immunity for making a good-faith report of suspected instances of financial exploitation of seniors to government agencies.

***Members of the Regulatory Forum will be asked to discuss ongoing efforts by regulators to address concerns regarding financial exploitation of seniors in the financial services marketplace.***

G. SEC Risk Alert - Cybersecurity - Credential Compromise.

The SEC's OCIE recently issued a Risk Alert to report that the SEC has observed in recent examinations an increase in the number of cyber-attacks against investment advisers and broker-dealers using credential stuffing which is a method of cyber-attack to client accounts that uses compromise client login credentials resulting in the possible loss of customer assets and unauthorized disclosure of sensitive personal information. (See copy attached.)

***Members of their Regulatory Forum will be asked to discuss regulatory concerns regarding potential cybersecurity risks at financial services firms.***

**VII. Other Business.**

**DRAFT**

**Minutes  
Meeting  
of the  
2020 CEFLI Advisory Committee  
Thursday, January 23, 2020**

A meeting of the Advisory Committee (the "Committee") of The Compliance and Ethics Forum for Life Insurers ("CEFLI") was held on Thursday, January 23, 2020 at 10:00 AM EDT at The Residence Inn in Bethesda, Maryland.

The following individuals participated in the meeting in-person:

Larry Kosciulek (FINRA)

Suzanne McGovern (SEC)

Joseph Valenti (AARP)

The following individuals participated in the meeting via conference call:

Lois Alexander (NAIC)

Gary Sanders (NAIFA)

Also participating in the meeting were Donald J. Walters, President & CEO of CEFLI and Carla Strauch, Vice President - Compliance & Ethics of CEFLI.

The meeting was called to order by Mr. Walters, who presided. Mr. Walters acted as Secretary of the meeting.

**I. Welcome and Introduction.**

Mr. Walters welcomed the Committee members and referred to CEFLI's antitrust statement to alert Committee members that an objection would be made to any discussion that might engender a potential violation of the antitrust laws.

**II. Approval of Minutes – October 10, 2019 Meeting.**

On motion, duly made and seconded and unanimously carried, the Committee: RESOLVED, that, the Minutes of the October 10, 2019 meeting of CEFLI's Advisory Committee are hereby approved.

**III. Secure Act.**

The Committee discussed the implications of the passage of the SECURE (Setting Every Community Up for Retirement Enhancement) Act, with respect to the elimination of “stretch IRAs.” The change means distributions may no longer be stretched over the life of beneficiary and instead must be distributed within a 10-year timeline. The Committee discussed the implications of the elimination of “Stretch IRAs” broadly, as related to the work of financial professionals.

Members of the Committee noted their engagement and support during the legislative processes and their appreciation of the Act's expansion and broadening of available of plans to employers. A few concerns were also noted.

First, concerns in the event there is a significant annuity marketing push, given individuals may already have pension plans with annuitization options. Second, concerns in the event an insurance company later develops financial difficulties. Third,

the fact that FINRA does not allow projections but may need to consider doing so, to align with the Act.

The role of longevity annuities was also discussed, along with the need to address three different retirement planning needs—longevity, immediate financial pressures (debt management, home repairs), and some type of payout between the two.

#### **IV. SEC Regulation Best Interest and Form CRS Relationship Summary.**

Following the SEC's June 5, 2019 issuance of Regulation Best Interest and Form CRS, firms have been developing compliance strategies aimed at complying with the new requirements. FINRA developed a Regulation Best Interest Webpage with a helpful "checklist" of issues for firms to consider and the SEC issued a series of Frequently Asked Questions regarding Regulation Best Interest and Form CRS.

The Committee discussed compliance challenges and strategies related to Regulation Best Interest and the Form CRS Relationship Summary. CEFLI's recent Summit Meeting on *The Future Sales Standards in the Life Insurance Industry* was noted, along with FINRA's Regulation Best Interest training, as industry members sought implementation guidance and insight regarding how to demonstrate that appropriate systems are in place.

It was noted that some smaller firms are struggling with developing their compliance strategies. Other firms appear to be struggling with what to put on the CRS Relationship Summary Form and how to deliver the Form. While some larger firms

(who readied themselves for the DOL Rule) may be further ahead, a few larger firms reportedly have taken minimal action, to date.

There was some discussion regarding whether the SEC would allow a link to disciplinary actions information on the Form, while recognizing the Form will not always be delivered electronically and the fact some consumers may not have access to a computer.

The SEC indicated it may not opt to take enforcement action immediately following the effective date of the regulation if a firm has some holes in its compliance strategy but can demonstrate diligent and timely efforts to comply. It was suggested that firms should leverage guidance provided in FINRA's Compliance Checklist and in the SEC's FAQs.

#### **V. FINRA and the SEC Examination Strategies – Regulation Best Interest.**

While Regulation Best Interest does not become effective until June 30, 2020, both FINRA and the SEC have indicated their exam activities prior to the effective date will include an assessment of a firm's degree of readiness for complying with the requirements of Regulation Best Interest.

The Committee discussed planned examinations strategies for assessing firms' readiness. It was suggested that firms should focus on the factors listed in FINRA's Examination Priorities Letter. Further, firms who are found to be unprepared can expect to have a follow-up visit. FINRA also noted its efforts to train examiners, with support from the SEC, regarding any interpretive matters.

## **VI. SEC and NYDFS Investigations of 403(b) Plan Annuity Sales.**

The Committee was asked to discuss current developments related to the SEC's investigation of 403(b) plan annuity sales conducted through broker-dealers or registered investment advisers and the New York Department of Financial Services' investigation regarding the manner in which 403(b) plan annuities are sold to educators.

The Committee discussed the importance of having complete and balanced presentations (including full disclosure of fees and expenses and a discussion regarding alternative products) when discussing annuities with enrollees. As educational institutions expand their product offerings in 403(b) plans, it is recognized some teachers don't understand they have a 403(b) plan or what that means. Additionally, California has an open architecture that allows anyone to go into a school and sell these types of products. It was suggested that firms may wish to review of FINRA's December 12, 2019 press release regarding U.S. investors' confusion related to investment account fees.

## **VII. Possible Rescission/Modification to Current FINRA Rules.**

During the Committee's prior meeting, the possible rescission or modification of current FINRA Rules in light of the issuance of Regulation Best Interest was discussed.

It was noted that FINRA continues to work through its comprehensive analysis regarding the implications of Regulation Best Interest and the identification of existing rules that may be impacted (e.g., cash/noncash compensation, sales contests, etc.).

For example, FINRA is exploring whether noncash compensation rules may need to comply with Regulation Best Interest since Regulation Best Interest does not permit sales contests based on the sale of certain types of products (but does allow contests based on asset accumulation).

#### **VIII. Regulation Best Interest Lawsuit.**

Seven states and the District of Columbia recently filed suit challenging the legality of the SEC's issuance of Regulation Best Interest. The lawsuit seeks to vacate the rule alleging the SEC exceeded its statutory authority when issuing the Regulation, alleging the Regulation does not meet standards required under the Dodd Frank Act, and citing the Regulation as capricious and arbitrary.

The Committee was offered the opportunity to discuss current developments regarding the lawsuit. No new developments were noted.

#### **IX. FINRA and SEC 2020 Examination Priorities.**

Both FINRA and the SEC recently released their 2020 Examination Priorities Letters. FINRA's focus areas include examining firms' readiness for complying with Regulation Best Interest, communications to retail investors, and variable annuities. The SEC's focus areas include the importance of compliance programs, the Chief Compliance Officer, and the role of compliance professionals in a firm.

The SEC noted its plan to evaluate a firm's compliance based on several factors including: (1) whether compliance is "actively engaged" in a firm's operations; (2) whether the Chief Compliance Officer is knowledgeable and empowered with "full

responsibility, authority and resources” to develop and enforce policies and procedures; and (3) whether the firm has a commitment from top executives who establish a “tone at the top that compliance is integral to the organization’s success.”

During the Committee’s discussions, FINRA noted its recent reorganization has resulted in the consolidation of previous areas (e.g., sales practices, market regulation, financial programs, etc.) into five (5) new areas: retail, capital markets, carrying and clearing, trading and execution, and diversified. FINRA’s December 12, 2019 press release addressed the manner in which firms are assigned; a movement from ‘regional’ to ‘type of firm’ categorization (e.g., retail capital markets, trading and clearing, etc.). The SEC’s program continues to be organized by geographical region.

In addition to reviewing FINRA’s Examination Priorities Letter and its recently published disciplinary actions, firms may benefit from continued focus on variable annuities sales, Regulation Best Interest readiness efforts, private placements, social media (and related record-keeping), cash management and bank sweep accounts, cybersecurity, etc. Firms may also benefit from a continued focus on efforts related to fraud, sales conflicts, disclosures, policies and procedures, individuals targeting certain markets (e.g., retirement communities, teachers, military, etc.), sales of high risk products (e.g., complex products, those with high fees, selling affiliations), etc.

The discussion noted the fact that the SEC conducts regular examinations of FINRA to evaluate FINRA’s operations and examination programs.

**X. NAIC Annuity Suitability (A) Working Group.**

The NAIC Executive and Plenary Committee will meet to consider approval of the updated Annuity Suitability Model Regulation on February 13th. The revised Model seeks to track key elements of SEC Regulation Best Interest.

Members of the Committee discussed their efforts to track the work of the NAIC Annuity Suitability (A) Working Group and they expressed their support of the adoption of amendments to the Model. It was recognized that some guidance may be needed regarding how to identify material conflicts of interest.

**XI. Fiduciary Legislation in the States - Massachusetts.**

Over the past few months, several states have introduced and enacted fiduciary legislation which would require financial advisers to abide by a fiduciary standard when working with customers.

Massachusetts Secretary of the Commonwealth, William Galvin, introduced a proposal in Massachusetts to establish a Fiduciary Conduct Standard and a public hearing was held on January 7 for which several industry organizations submitted comments, including NAIFA, ACLI, SIFMA, FSI, and the joint trades. The NAIFA and ACLI CEOs also testified at the hearing.

Members of the Committee noted the proposed legislation could drive producers to a fee-based business model. The proposal is anticipated to move forward quickly. Aside from the proposal's inclusion of fixed and variable life insurance and annuities, the legislation appears similar to legislation introduced in New Jersey which will need to

be fully reintroduced if it does not gain traction in the next month. The proposal to implement a Nevada fiduciary law appears to be on hold.

## **XII. DOL Fiduciary Rule.**

Recent media reports suggest there has been coordination between the SEC and the US Department of Labor (“DOL”) as it relates to the SEC’s development of Regulation Best Interest and the same reports indicated that there was a likelihood that the DOL would issue, prior to the end of 2020, a revised version of its DOL Fiduciary Rule vacated by the Fifth Circuit in March 2018.

Members of the Committee had no new updates.

## **XIII. Senior Issues.**

### **A. Senior Safe Act - Training.**

The Senior Safe Act, signed into law on May 24, 2018, provides immunity from liability in any civil or administrative proceeding for reporting potential exploitation of a senior provided employees received training on the Act. Such employees include individuals who serve as supervisors in a compliance or legal function for a covered financial institution, registered representatives, investment adviser representatives, and insurance producers affiliated or associated with a covered financial institution.

The Committee discussed the collaborative efforts of the SEC, FINRA and NASAA to develop a joint, online training module. Progress tests will be

embedded within the content and firms will have the ability to add their own content to the module.

B. Other Senior Initiatives.

FINRA, the SEC and AARP have been actively involved in developing programs and information resources to assist senior investors. Specifically, FINRA and AARP have worked closely to develop initiatives designed to assist senior investors in making wise choices and avoiding potential frauds. FINRA and the SEC have developed “help lines,” published “risk alerts” and issued rules [e.g., FINRA Rules 4512 (Customer Account Information) and 2165 (Financial Exploitation of Specified Adults)], to better inform senior investors of potentially fraudulent activities. Select state securities and insurance departments and others state regulatory authorities also have taken steps to encourage reporting of suspected instances of financial exploitation of seniors and vulnerable adults.

The Committee discussed additional efforts underway. Specifically, the issuance of FINRA’s Regulatory Notice 19-27 which sought comments about senior investors issues and whether FINRA should update any of its existing rules related to senior needs. FINRA is currently reviewing the comments it has received.

**XIV. FINRA-NAIC Information Sharing – Licensing Registered Representatives and Insurance Producers.**

FINRA previously agreed to share registered representative disciplinary history information with the NAIC. This information has been forwarded to state insurance

departments by the NAIC so state insurance departments may review their records to determine whether registered representatives against whom FINRA may have taken disciplinary action may also hold a state insurance producer's license.

Recent media reports indicated FINRA and the NAIC developed a memorandum of understanding on sharing licensing information for registered representatives and insurance producers. Accordingly, the Committee was asked to discuss any recent developments related to information sharing between FINRA and the NAIC.

During the Committee discussion it was noted that FINRA's registered representative disciplinary history is being shared with the NAIC and that the NAIC subsequently forwards the information to the individual state insurance departments who can, but are not obligated to, take action.

## **XV. Update on NAIC Activities.**

### **A. NAIC Committee Chairs Announced.**

The NAIC recently announced their Committee Chairs for 2020.

Committees related to life insurance regulation include:

NAIC Life Insurance and Annuities (A) Committee:

Chair: Jillian Froment, Director, Ohio Department of Insurance

Vice Chair: Pending

NAIC Market Regulation and Consumer Affairs (D) Committee:

Chair: Allen Kerr, Commissioner, Arkansas Insurance Department

Vice Chair: Barbara Richardson, Commissioner, Nevada Department of Business and Industry, Division of Insurance

B. NAIC Big Data (EX) Working Group.

The NAIC has established the NAIC Big Data (EX) Working Group to, among other issues, review current regulatory frameworks used to oversee insurers' use of consumer and non-insurance data.

Recently, regulators have turned their attention to the life insurance industry to determine the nature and types of data that are used by life insurers as part of their underwriting process for life insurance policies.

Areas of regulatory focus have included the types of data being used, the ability of insurers to verify the accuracy of that data and the ability of consumers to challenge the accuracy of data that may have been used in a life insurance policy underwriting decision.

The Committee's discussion acknowledged the benefit of retaining the NAIC's charge and the value of additional transparency, with consumers, as it related to insurers' use of data and disclosure regarding how such data is used.

C. NAIC Accelerated Underwriting (A) Working Group.

Life insurers are exploring methods to accelerate the underwriting process to expedite the application process to obtain life insurance without having to undergo medical tests.

Given the increased prevalence of "accelerated underwriting" practices among insurers, the NAIC has established an Accelerated Underwriting Working

Group to consider the use of external data and data analytics in accelerated life insurance underwriting.

D. NAIC Artificial Intelligence (EX) Working Group.

Insurers have been exploring the ways in which artificial intelligence can be applied to insurance company business practices to provide more efficient outcomes and expedite the insurance purchasing process for consumers.

Therefore, the NAIC has established its NAIC Artificial Intelligence (EX) Working Group to study the development of artificial intelligence and its use in the insurance sector.

**XVI. NAIC Lost Policy Locator Service.**

The NAIC maintains its Lost Policy Locator Service as a means to consolidate information provided previously by individual state-specific websites designed to assist life insurance companies to identify potential beneficiaries of life insurance policy proceeds.

The NAIC reportedly has been working collaboratively with the ACLI to develop enhancements to the Lost Policy Locator Service. The required data points have been reduced from 68 to 6. Additionally, modifications have been made to prevent consumers from continual submissions. There have been discussions between LICONY and the NYDFS to consider having NY participate. Both Louisiana and Ohio recently deferred to the NAIC program, leaving only five state-specific programs in effect.

## **XVII. FINRA Consolidation of Broker Exam Functions into One Program.**

FINRA recently announced consolidation of several broker exam functions into one singular program. The effort is designed to streamline examinations of 3,600 broker-dealers and 630,000 registered representatives within its jurisdiction.

The consolidation will bring FINRA's business conduct, financial reporting and training compliance exam programs under a single framework.

## **XVIII. SEC Proposes Updates to Advertising Rules.**

The SEC recently proposed updates to its Advertising Rule that would allow registered investment advisers (RIAs) to use testimonials, endorsements and third-party ratings to solicit clients, subject to certain conditions. The proposal also includes requirements for presentation of performance results, based on the intended audience for the advertisement.

Members of the Committee speculated RIAs would favor a rule change since it would aid in competition. Currently, FINRA allows testimonials conditionally (if payment is disclosed and is within the ceiling allowed) and is continuing to review the comments it received.

## **XIX. Fraud Awareness.**

Those who may choose to perpetrate frauds have no limit to their creativity. Firms and life insurance companies must be ever vigilant to identify and detect such frauds in order to protect corporate and consumer interests.

The Committee was asked to share insight regarding any new types of fraud that have arisen over the past several months that may be of concern to life insurers.

Members of the Committee were not aware of new fraud areas but noted continued use of existing scams such as fake IRS calls regarding an alleged Social Security number compromise, the grandparent scheme, computer pop-up schemes alleging to fix a computer virus, efforts to impersonate investors during calls, etc.

During the discussion, it was noted that the NAIC's Antifraud unit is seeing more money laundering concerns and concerns regarding the use of funds to defraud (with drug treatment centers).

#### **XX. Contemporary Compliance and Ethics Challenges.**

The Committee was asked to comment on their observation of contemporary compliance and ethics challenges in the marketplace for life insurance and annuity products that may warrant further review by CEFLI's Compliance and Ethics Committee.

The discussion noted the need for a continued focus on SEC Regulation Best Interest and the need to help consumers understand what the regulation means to them.

#### **XXI. Other Business.**

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

## 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.<sup>1</sup> 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.

May 28, 2020

#### 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

## 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<sup>2</sup> 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<sup>3</sup> 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.”).

Draft: 9/4/20

Comments are being requested on this draft document by Oct. 2, 2020. Comments should be sent only by email to Jolie Matthews at [jmatthews@naic.org](mailto:jmatthews@naic.org).

## ***SUITABILITY IN ANNUITY TRANSACTIONS MODEL REGULATION (#275)***

### **BEST INTEREST STANDARD OF CONDUCT REVISIONS**

#### ***FREQUENTLY ASKED QUESTIONS***

This Frequently Asked Questions (FAQ) document is intended to specifically address those questions that are likely to arise as the states work to adopt the revised *Suitability in Annuity Transactions Model Regulation (#275)* and to assist in the uniform implementation and enforcement of its provisions across all NAIC member jurisdictions. No provision of this FAQ document is intended to supersede the specific language in Model #275.

This FAQ document is offered to any state that chooses to use it. It is not intended to expand the content of the model regulation but provides interpretive guidance regarding certain aspects of its provisions.

#### **GENERAL**

##### **Q1. Why did the NAIC decide to revise the model to include a best interest standard of conduct?**

A1. The revised model was developed, in part, in response to the U.S. Department of Labor's (DOL) fiduciary rule, which was finalized in April 2016 but vacated in its entirety in March 2018. The DOL fiduciary rule would have expanded the scope of who is considered a fiduciary to federal Employee Retirement Income Security Act of 1974 (ERISA) retirement plans and individual retirement accounts (IRAs) to include a broader set of insurance agents, insurance brokers and insurers. Separately, the U.S. Securities and Exchange Commission (SEC) released a proposed rule package in May 2018, which included Regulation Best Interest (Reg BI). The SEC finalized Reg BI in June 2019. The final Reg BI establishes a best interest standard of conduct for broker-dealers beyond the existing suitability obligation that applies to federally registered variable annuities. Recognizing the SEC's and the DOL's role in the regulatory landscape and believing that consumers are better protected when, to the extent possible, there is harmonization of the regulations enforced by the states, the SEC and the DOL, the NAIC revised the model to establish a framework for an enhanced standard of conduct that is more than the model's current suitability standard but not a fiduciary standard.

##### **Q2. How does the Harkin amendment, Section 989J of the Dodd-Frank Act apply to the revised model?**

A2. Section 989J confirms state authority to regulate the sale of fixed indexed annuities and exemption from federal securities regulation when certain conditions are met, including when the state in which the contract is issued or the state in which the insurer issuing the contract is domiciled: 1) has adopted requirements that "substantially meet or exceed the minimum requirements" established by the 2010 version of the NAIC's *Suitability in Annuity Transactions Model Regulation (#275)*; and 2) "adopts rules that substantially meet or exceed the minimum requirements of any **successor modifications** to the model regulation[]" within 5 years of the adoption by the NAIC. The only exception to this requirement is if the product is issued by an insurance company that adopts and implements practices on a nationwide basis that meet or exceed the minimum requirements established by the NAIC's Model #275, "and **any successor thereto**," and is therefore subject to examination by the State of domicile or by any other State where the insurance company conducts sales of such products.

The NAIC considers the 2020 revisions to be a successor modification to the model that exceeds the requirements of the 2010 revisions, which is reflected in a drafting note to Section 1—Purpose:

“Section 989J of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”) specifically refers to this model regulation as the “Suitability in Annuity Transactions Model Regulation.” Section 989J of the Dodd-Frank Act confirmed this exemption of certain annuities from the Securities Act of 1933 and confirmed state regulatory authority. This regulation is a successor regulation that exceeds the requirements of the 2010 model regulation.”

As such, states need to work toward adopting the 2020 revisions within 5 years after its adoption by the full NAIC membership in February 2020 to maintain their authority to regulate the sale of fixed annuities.

## **EXEMPTIONS**

**Q3. What is the intent of the exemption to the revised model’s provisions under Section 4A to allow a consumer in response to a direct response solicitation to purchase an annuity product where no recommendation is made based on information collected from the consumer?**

A3. This exception from the rule was in the 2010 model rule and was not changed in the 2020 version. A direct-response solicitation is a solicitation through a sponsoring or endorsing entity solely through mails, the Internet, a digital platform, or other mass communication media that does not involve a communication directed to a specific individual by a natural person, or by a simulated human voice.

## **BEST INTEREST STANDARD OF CONDUCT**

**Q4. What is the best interest standard of conduct and how would a producer or insurer satisfy it?**

A4. To satisfy the best interest obligation, a producer or an insurer must satisfy the four obligations: 1) care; 2) disclosure; 3) conflict of interest; and 4) documentation.

To satisfy the four obligations, when making a recommendation, producers must:

- Know the consumer’s financial situation, insurance needs and financial objectives;
- Understand the available recommendation options;
- Have a reasonable basis to believe the recommended option effectively addresses the consumer’s financial situation, insurance needs and financial objectives;
- Communicate the basis of the recommendation to the consumer;
- Disclose their role in the transaction, their compensation, and any material conflicts of interest; and
- Document, in writing, any recommendation and the justification for such recommendation.

**Q5. What types of recommendations fall under the best interest standard of conduct?**

A5. All recommendations made by a producer or insurer to purchase, exchange or replace an annuity product must comply with the best interest standard of conduct. Specifically, as defined in Section 5M, a “recommendation” is advice provided by a producer to an individual consumer that was intended to result or does result in a purchase, an exchange or a replacement of an annuity in accordance with that advice. A recommendation does not include general communication to the public, generalized customer services assistance or administrative support, general educational information and tools, prospectuses, or other product and sales material.

**Q6. Does the best interest standard of conduct apply to a producer who never meets the client, but assists a producer in making a recommendation to the client?**

A6. Yes, under Section 6A(5), a producer who has exercised material control or influence in the making of a recommendation and has received direct compensation as a result of the recommendation or sale, regardless of whether the producer has had any direct contact with the consumer.

### **CARE OBLIGATION**

**Q7. What is the intent of language in Section 6A(1)(c), which states “Producers shall be held to standards applicable to producers with similar authority and licensure?”**

A7. The intent of this language is to help to ensure that in any compliance or enforcement action, a producer’s recommendation is compared only to other producers as opposed to being compared to investment advisers or possibly higher-level fiduciaries, such as trust officers or plan sponsors under the federal Employee Retirement Income Security Act of 1974 (ERISA) for compliance and enforcement purposes.

### **DISCLOSURE OBLIGATION**

**Q8. To satisfy the disclosure obligation, Section 6A(2)(a) requires a producer to provide the completed “Insurance Agent (Producer) Disclosure for Annuities” form in Appendix A prior to a recommendation, can a producer provide the form at the initial client meeting? Is the producer required to update the form and provide it again or can the producer provide it once and satisfy this obligation?**

A8. Yes, a producer can satisfy the disclosure obligation by providing a completed form during the initial client meeting. However, if, after the completed form is provided to the client, the information on the completed form becomes out-of-date prior to a recommendation, the producer is expected to provide the consumer with an updated form.

### **CONFLICT OF INTEREST OBLIGATION**

**Q9. As defined in Section 5I(2), a material conflict of interest does not include cash compensation or non-cash compensation, what other type of financial interest would be considered a material conflict of interest? Is it only an ownership interest as referenced in Section 6A(3)?**

A9. A producer who is also dually registered as an investment advisor under state securities law is required under Section 6A(3) to reasonably manage and disclose the related conflicts of interest. This management must commence when the producer first meets with a potential customer even before the dually licensed producer knows the ultimate capacity in which the producer will be acting. The actual capacity when the producer executes a specific transaction may not be known early in the relationship and the related professional or contractual obligations may not be determined based upon the specific facts and circumstances and the consumer profile information until later in the relationship, thus creating a conflict of interest for the producer. The dually licensed producer should assume that both Model #275 and the Investment Advisers Act apply, and that the producer must manage and disclose the conflict of interest.

**Q10. Under Section 6A(3), to satisfy the conflict of interest obligation, what must a producer do to identify and avoid or reasonably manage a material conflict of interest? Examples?**

A10. The differences in professional and contractual obligations between a producer acting in the consumer's best interest at the time of the transaction and an investment advisor acting in the consumer's best interest over the term of a professional advisory contract are substantial. Managing this conflict of interest will require more than simple disclosure. The dually licensed producer must ensure that the customer has a timely comprehension of the producer's varied interests in the relationship decisions and the producer must ultimately and before making a recommendation have a reasonable basis to believe the producer's recommended professional relationship or

capacity along with any related annuity recommendation effectively addresses the consumer's financial situation, insurance needs and financial objectives.

## **SUPERVISION SYSTEM**

**Q11. Do these revisions require insurers to set up new supervision systems to ensure producer compliance with this new standard of conduct?**

A11. No, but the revisions do add additional insurer supervision requirements by requiring insurers to establish and maintain reasonable procedures in three additional areas:

- To assess whether a producer has provided to the consumer the information required by the revised model.
- To identify and address suspicious consumer refusals to provide consumer profile information.
- To identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific annuities within a limited period of time.

**Q12. Section 6C(2)(h) requires an insurer as part of its supervision system to identify and eliminate sales contests, quotas, bonuses, and non-cash compensation based on the sale of specific annuities within a limited period of time. What type of business practices is provision intended to address?**

A12. The requirements of Section 6C(2)(h) are not intended to prohibit general incentives regarding sales of an insurance company's products where there is no emphasis on a particular product. As the provisions states, insurer business practices involving sales contests, quotas, bonuses and non-cash compensation based on the sale of a specific annuity or annuities within a specified or limited period of time are prohibited and should be identified and eliminated.

## **TRAINING**

**Q13. Do producers complete additional training on the new standard of conduct even if they have already completed the existing annuity training requirements?**

A13. Yes, Section 7 requires a producer who has already completed the existing annuity training requirements prior to a state's effective date of the revised model to complete within 6 months of that date either a four credit training course or an additional one-time one credit training course on the appropriate sales practices, replacement and disclosure requirements under the revised model. In adopting this section, a state could choose a different timeframe for this requirement.

NASAA  
REGULATION BEST  
INTEREST  
IMPLEMENTATION  
COMMITTEE

REGULATION  
BEST INTEREST:  
National  
Examination  
Initiative  
Phase One

September 2020



**NASAA**

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

## Introduction

NASAA’s Regulation Best Interest (“Reg BI”) Implementation Committee (the “Committee”) led a coordinated national examination initiative in the first quarter of 2020. The purpose of the examination initiative was to identify a baseline of broker-dealer (“BD”) and investment adviser (“IA”) firm policies, procedures, and practices involving sales to retail investors, as those policies, procedures, and practices existed in 2018 prior to adoption and release of the final rule by the SEC (the “pre-BI period”).<sup>1</sup> Together with a second examination initiative scheduled to start in 2021 (the “post-BI period”), states will be able to evaluate key industry changes as firms seek to achieve compliance with Reg BI and the SEC’s updated interpretation of investment advisers’ fiduciary duties under the 1940 Advisers Act. This information is critical to inform states as they update their own state regulations, policies, and examination practices in light of the new federal standards.

In mid-February 2020, 34 states participating in the initiative sent examination questionnaires to more than 2,000 firms (BD and IA) operating in their jurisdictions. States were asked to distribute surveys on a 1:3 BD to IA ratio, given the larger size of the latter registrant population. Firms were given two weeks to return responses and an additional week to produce copies of applicable policies and/or forms.

The top 10 priority areas in the coordinated examination initiative included:

- Variations in the types of products sold
- Policies, procedures, and practices related to the sale of alternative or complex product types, with specific attention to private securities, non-traded Real Estate Investment Trusts (“REITs”), leveraged or inverse exchange-traded funds (“ETFs”), and variable annuities
- Policies, procedures, and practices regarding sales contests, quotas, bonuses, and the receipt of non-cash compensation
- Policies, procedures, and practices with respect to recommendations as to account type and IRA/retirement account rollovers
- Cost comparison due diligence and disclosure practices
- Compensation policies, procedures, and practices involving receipt of third-party compensation and the payment of differential compensation

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<sup>1</sup> Regulation Best Interest, SEC Rel. No. 34-86031, File No. S7-07-18 (Jun. 5, 2019), available at <https://www.sec.gov/rules/final/2019/34-86031.pdf>.

**NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020**

- Policies, procedures, and practices regarding disclosure, avoidance, or mitigation of material financial conflict incentives
- Policies, procedures, and practices regarding point of sale disclosures
- Types of information collected in customer profile forms and/or suitability questionnaires
- Titles used to describe registered agents/representatives, e.g., advisor, adviser, wealth manager, or financial consultant, while operating in the capacity of a broker-dealer.

Below are the Committee's findings. Attached to this report are charts summarizing select responses from broker-dealer firms on a consolidated basis (Appendix A) and select responses from investment adviser firms on a consolidated basis (Appendix B). Questions regarding the exam initiative may be directed to the Committee Chair, Ohio Securities Commissioner Andrea Seidt at [andrea.seidt@com.ohio.gov](mailto:andrea.seidt@com.ohio.gov).

## PHASE I FINDINGS

### SURVEY SAMPLE

- 34 Participating States: Alabama, Alaska, Arkansas, California, Colorado, Connecticut, District of Columbia, Delaware, Florida, Georgia, Illinois, Indiana, Kentucky, Louisiana, Maryland, Michigan, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Jersey, New Mexico, New York, Ohio, Oklahoma, Oregon, Rhode Island, Texas, Vermont, Washington, West Virginia, Wisconsin, and Wyoming.
- 2,068 firms completing surveys citing 2018 data:<sup>2</sup>
  - 516 BDs (approximately 15% of the registered FINRA population);<sup>3</sup>

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<sup>2</sup> On February 25, 2020, the following industry trade associations sent a joint letter to states objecting to various aspects of the examination tool as well as the timeline and requested states to suspend the examination initiative: Alternative & Direct Investment Securities Association (ADISA), American Securities Association (ASA), Financial Services Institute (FSI), Institute for Portfolio Alternatives (IPA), Insured Retirement Institute (IRI), Money Management Institute, National Association of Insurance and Financial Advisors (NAIFA), Securities Industry and Financial Markets Association (SIFMA), and the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness. The Committee Chair responded to the letter the following day, that the initiative would not be suspended. While a few states agreed to short extensions on a case-by-case basis, member firms by and large complied with the state exam initiative on time and within requested parameters.

<sup>3</sup> To maximize the retail customer reach of this survey, the Committee made a conscious effort to include the top fifty largest broker-dealer firms based on number of agents/representatives, whether those firms were standalone broker-dealers or dually licensed as both broker-dealers and investment advisers.

**NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020**

- 1,552 IAs (approximately 9% of the state-registered population);<sup>4</sup>
- Firms ranging in size from 1 person to >35,000 agents/representatives, approximately 360,000 registered persons in total;
- Firm revenue ranging between \$0 to nearly \$22 billion, more than \$106 billion in total;
- Retail customer base ranging from 0 (new firms) to >10 million accounts, over 68 million retail accounts in total.

## PRODUCT OFFERINGS

In 2018, prior to Reg BI, most firms were engaged in the sale of conventional securities like stocks and mutual funds in traditional asset classes like equities and fixed income. Broker-dealers offered a more diverse set of product offerings than IAs, but that menu included a number of complex and high-commission products higher on their lists. Indeed, while leveraged- and inverse-ETFs appear in the IA Top 10 list below, sold by at least 15% of IA firms, a higher percentage of BDs (25%) reported selling them outside of the BD Top 10. IAs focused more on plain vanilla products. Interestingly, almost the same percentage of IA and BD firms – 37-38% – offered no-load products to their customers. Few firms had policies and procedures governing specific product sales (26%) or used tools to assist agents/representatives and investors in comparing investment opportunities (19%).

- On a consolidated firm basis, the top 5 most common product types offered or made available to customers were: (1) mutual funds (75%); (2) equities (73%); (3) debt/fixed income (65%); (4) standard ETFs (64%); and (5) listed REITs (40%).
- The 5 product types presented in the survey that were least commonly offered or made available to customers included: (1) cryptocurrency (0.44%); (2) highly leveraged products (2%); (3) proprietary products (4%); (4) derivatives (4%); and (5) hedge funds (6%).

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<sup>4</sup> Although some federal advisers were surveyed, most states focused on state-registered firms over which they have primary authority.

**NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020**

	<b>Top 10 BD Products</b>	<b>Top 10 IA Products</b>
1.	Mutual funds (66%)	Mutual funds (77%)
2.	Equities (60%)	Equities (77%)
3.	Debt/Fixed income (57%)	Debt/Fixed income (67%)
4.	Standard ETFs (52%)	Standard ETFs (67%)
5.	Municipal funds (50%)	Listed REITs (39%)
6.	Variable annuities (49%)	No-load products (37%)
7.	Listed REITs (44%)	Municipal funds (33%)
8.	Options (44%)	Options (23%)
9.	No-load products (38%)	Variable annuities (15%)
10.	UITs (37%)	Leveraged- or inverse-ETFs (15%)

## SALES OF COMPLEX PRODUCTS

NASAA has focused much of its Reg BI examination focus on complex and high-risk products, namely, private securities, variable annuities, non-traded REITs, and leverage- or inverse-ETFs, due to investor confusion and harm emanating from these products. Only a minority of firms surveyed offered or sold these products in 2018. Even with the country’s largest broker-dealers and smallest state-registered investment advisers in the survey mix, 64% of the firms surveyed did not recommend or make *any* of these products available to their customers. When they were sold, however, broker-dealers were much more likely than investment advisers to place these products.

<b>PRODUCTS</b>	<b>ALL FIRMS COMBINED</b>	<b>BD</b>	<b>IA</b>
Private securities	7%	21%	3%
Variable annuities	14%	42%	5%
Non-traded REITs	6%	18%	2%
Leveraged- or Inverse-ETFs	9%	15%	7%

## INVESTOR PROFILE QUESTIONNAIRE FORMS

One of a firm's most important tools in getting to know their customers' investment needs and objectives is the investor profile questionnaire. A large majority of firms surveyed use them, but there was a small percentage who reported *not* using them. IA questionnaires were generally more robust than BD questionnaires in collecting vital "know your customer" information, but both BDs and IAs have room to improve by collecting important information like education level and debt.

- 22% of BDs indicated they did not use investor profile questionnaires, compared to 13% of IAs.
- Top five areas covered: (1) investment objective (80%); (2) age (80%); (3) risk tolerance (79%); (4) income (78%); and time horizon (77%).
- Only 20% of the firms asked about education level; 42% asked about debt.
- BD v. IA questionnaires:
  - Investment objective – BD (72%) v. IA (83%);
  - Age – BD (72%) v. IA (82%);
  - Risk tolerance – BD (70%) v. IA (80%);
  - Income – BD (72%) v. IA (80%);
  - Time horizon – BD (69%) v. IA (79%);
  - Net worth – BD (73%) v. IA (77%);
  - Liquidity needs – BD (65%) v. IA (71%);
  - Other investments – BD (57%) v. IA (64%);
  - Education level – BD (17%) v. IA (21%);
  - Debt – BD (22%) v. IA (49%).
- The two areas where BDs gathered more information than IAs on investor profile questionnaires were in asking about years of investment experience [BD (64%) v. IA (59%)] and years of experience with specific products or asset classes [BD (60%) v. IA (51%)].

## **FEE DISCLOSURES AND ACCOUNT TYPES**

Most firms reported having policies and procedures related to fee disclosure but less than half reported providing fee disclosure at the most important point for the customer – the point-of-sale. It is unclear what level of point-of-sale disclosure, if any, will be required beyond prospectus delivery to satisfy the firm’s and the agent’s disclosure obligations under Reg BI. Firms will be expected under Reg BI to disclose whether there are lower-cost, suitable options available to their customers, whether on or outside their platforms, something most firms were not disclosing at the point of sale prior to Reg BI.

- 69% of firms had policies and procedures related to the disclosure of any fees.
- 30% of firms had policies and procedures regarding IRA/retirement account rollovers.
- 43% of firms disclose at point-of-sale the fees charged for various asset classes.
- 41% of firms disclose at point-of-sale the availability of lower-cost, suitable options on the firm’s platform.
- 35% of firms disclose at point-of-sale the availability of lower-cost, suitable options outside the firm’s platform.
- Firms fare slightly better regarding fee disclosure with respect to account type:
  - 64% of firms disclose prior to or at account opening the average fees for account type;
  - 48% of firms disclose pros and cons of selecting competing account type (e.g., brokerage v. advisory).
- While more IAs have applicable policies and procedures regarding fee disclosures as a whole (72% v. BDs at 60%), more BDs have policies and procedures applicable to IRA/retirement account rollovers (47% v. IAs at 25%) and variations in asset classes (49% v. IAs at 40%).
- IAs report greater fee disclosure at the point of sale: 40% of IAs disclosed availability of lower cost options outside the firm’s platform compared to 27% of BDs. Less than half of BDs (42%) and IAs (40%) disclose at point of sale the availability of lower cost options on the firm platform.

## COMPENSATION PRACTICES

Compensation practices vary widely from business model to business model and even from firm to firm within models. No particular account type is *ipso facto* better than any other type, and no one can say definitively what is in the best interest of any customer without first examining the facts and circumstances surrounding that customer. That said, certain compensation practices must be scrutinized closely as they create strong financial incentives (conflicts) for firms and their agents/representatives to select one account type or product over another. Sales contests and the receipt of third-party compensation are two compensation practices often discussed in this context. Reg BI prohibits sales contests based on the sales of specific securities and types of securities within a limited period of time (though the survey confirms firms are no longer engaging in this practice)<sup>5</sup> but allows product-agnostic contests and third-party compensation to continue, provided there is proper disclosure and mitigation. Based on firm survey responses, investors were more likely to find these two types of financial incentive conflicts at a BD than an IA firm.

- Virtually no firms used product-specific sales contests in 2018, the only type expressly prohibited under Reg BI. Zero IAs reported use of product-specific sales contests, quotas, or bonuses to compensate agents/representatives, compared to 2% of BDs.
- 15% of BDs did utilize sales contests, quotas, or bonuses that were not tied to a specific product in 2018 (in other words, a product-agnostic contest), a rare happening at an IA firm (only 1%).
- 18% of the BD firms accepted third-party compensation from a product manufacturer on account of sales/advice to customers, also rare at IAs (2%).
- 15% of the BD firms accepted third-party compensation from another broker-dealer, investment adviser, or other financial institution on account of sales/advice to customers, compared to only 3% of IAs.

## CONFLICTS OF INTEREST

One of the most important developments in the SEC's adoption of Reg BI is the new regulatory focus on conflict of interest disclosure and mitigation. Based on survey responses, firms on both the BD and IA side have a lot of work to do here. While all firms will now be expected to closely manage conflicts of interest, particularly those involving a financial incentive, only about half (59%) of the firms had specific policies and procedures pertaining to conflicts of interest when surveyed. Even fewer firms had tools

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<sup>5</sup> See SEC Rule 15l-1(a)(2)(iii)(D), 17 C.F.R. § 240.15l-1(a)(2)(iii)(D); Regulation Best Interest, *supra* note 1, at 351-56.

**NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020**

like conflict registers (24%) to manage them and conflict committees/officers (30%) to enforce them.

- 57% of BD firms with specific conflict of interest policies and procedures, compared to 59% of IAs.
- 30% of BD firms maintained a conflicts of interest register, compared to only 22% of IAs.
- 30% of BD firms had a conflicts of interest committee or designated officer, compared to 29% of IAs.

## TITLES

In 2018, many firms allowed their agents/representatives to use the “adviser” and “advisor” titles of trust in marketing activities they undertook in their broker-dealer capacity. Reg BI places restrictions on that activity moving forward, generally requiring investment adviser representative licensure and supervision.<sup>6</sup> Alternatively, firms also used titles like “wealth manager” and “financial consultant,” terms that are not restricted under Reg BI. Investors seeking the highest standard of care will need to continue exercising caution in taking any securities professional title at face value and may avoid confusion by simply asking their investment professionals whether or not they are receiving a fiduciary standard of care.

- 29% of firms allowed agents/representatives to use the “adviser” or “advisor” title while acting in a broker-dealer capacity; 46% of those firms had no prerequisites for using such title, such as requiring IAR registration.
  - More common in BDs than IAs, nearly 40% of the BDs allowed it compared to 26% of IAs.
- 14% of firms used alternative titles like “wealth manager” or “financial consultant.”
  - Also more common in BDs than IAs, 30% of the BDs allowed it compared to 9% of IAs.

## INSURANCE

A collateral issue raised in the Reg BI releases with respect to differences in the standard of care and protections for retail investors is the extent to which registered firms carry E&O insurance for investor losses. There is little in the way of publicly reported information regarding firm practice and coverage in this area so NASAA included a few short questions to better survey the landscape. NASAA found that over half of both the

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<sup>6</sup> See Regulation Best Interest, *supra* note 1, at 155-59.

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BD *and* IA firms surveyed carried E&O insurance, even where such insurance was not a regulatory requirement. Of course, financials for firms without insurance should be closely scrutinized and regulators/investors should inquire who and what is excluded from a firm policy in the event of loss.

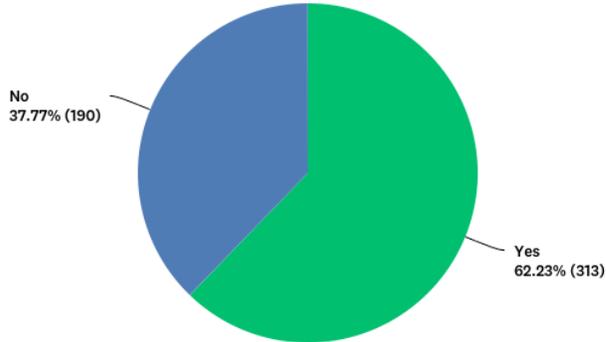
- 61% of firms carried E&O insurance – slightly more BDs (62%) than IAs (60%).
- 97% of the policies covered all registered persons at the firm:
  - BDs more likely to exclude certain individuals from coverage (7%) than IAs (2%).
- Select product exclusions from coverage included: private securities (5.5%), non-traded REITs (4%), leveraged or inverse ETFs (4%), and variable annuities (2%).

**APPENDIX A**

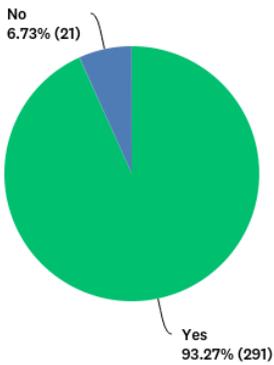
**BROKER-DEALER RESPONSES**

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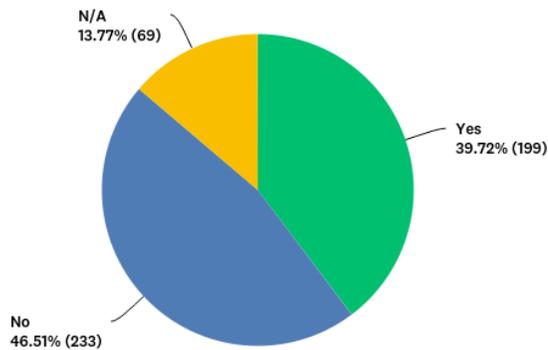
Q10 Does your firm carry E&O insurance?



Q13 Does this policy cover all registered persons?

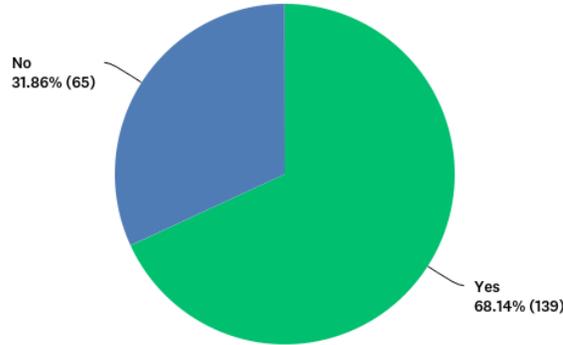


Q14 Please indicate if the firm or its registered agents/representatives use, or permit the use of, the title of "advisor" or "adviser" in marketing materials, disclosures, customer agreements, websites, or as a job title on business cards or in any form of social media to describe itself or its registered agents/representatives while operating in the capacity of a broker-dealer.

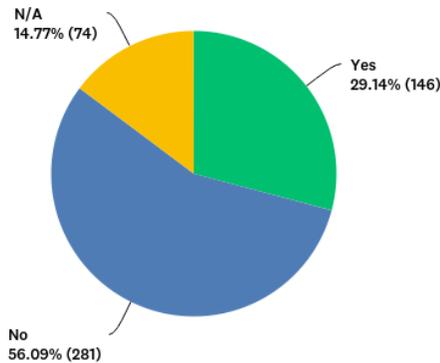


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PHASE I NATIONAL EXAM INITIATIVE 2020

Q15 Are there any prerequisites for such use as described in the previous question (e.g., dual registration)?

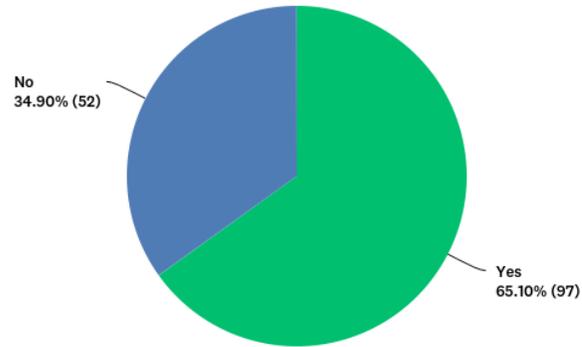


Q16 Please indicate whether the firm or its registered agents/representatives use, or permit the use of, the title of "wealth manager," "financial consultant," or similar title in marketing materials, disclosures, customer agreements, websites, or as a job title on business cards or in any form of social media to describe itself or its employees while operating in the capacity of a broker-dealer.



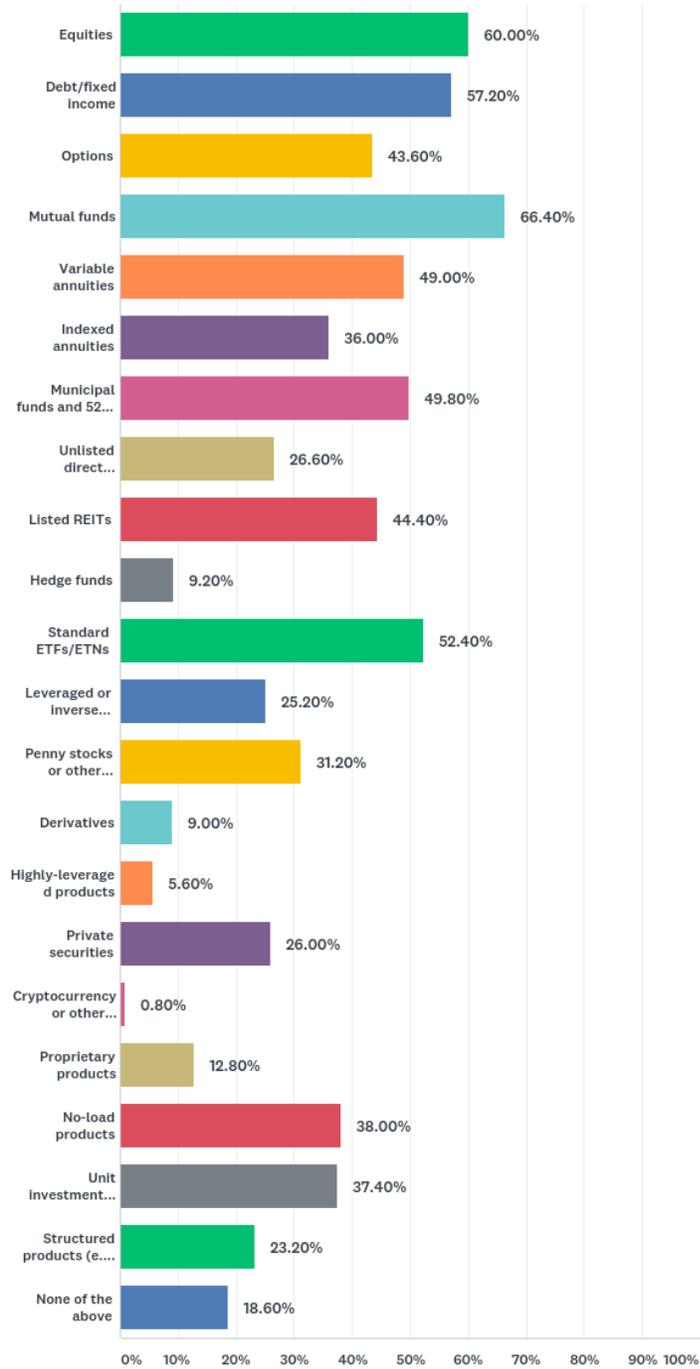
NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020

Q17 Are there prerequisites for such use as described in the previous question (e.g., dual registration)?



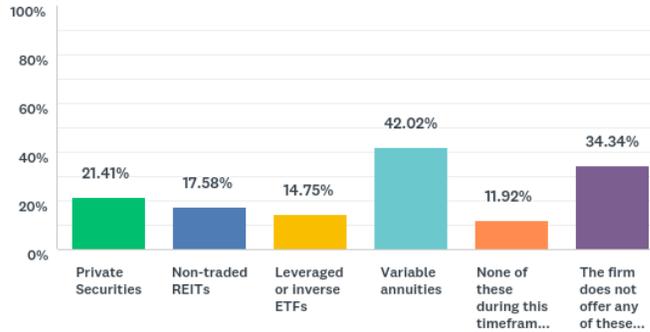
NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
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Q18 Products made available by broker-dealers:

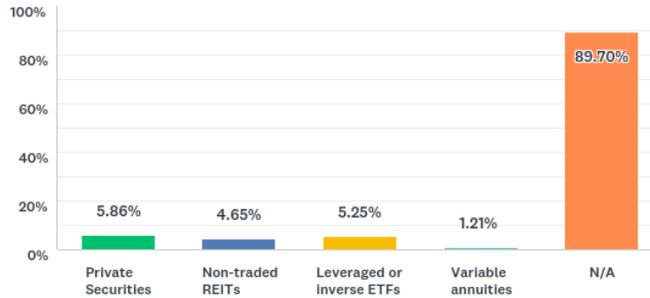


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Q19 Did you place customers in any of the following product types? Check all that apply.

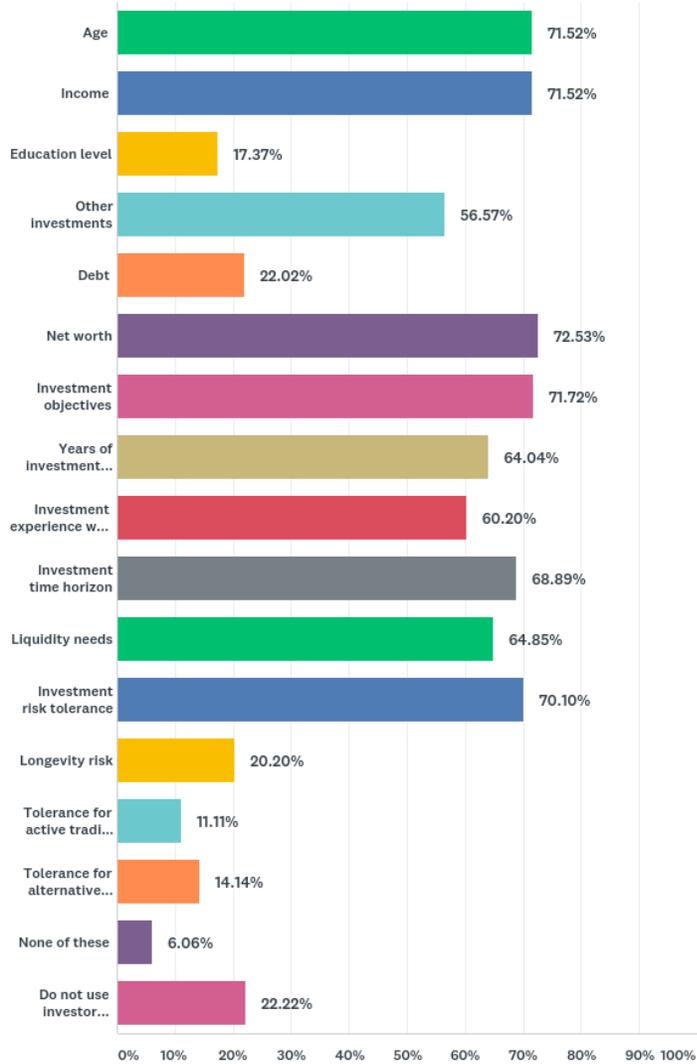


Q20 Are any of the following product types excluded from E&O coverage, if applicable?



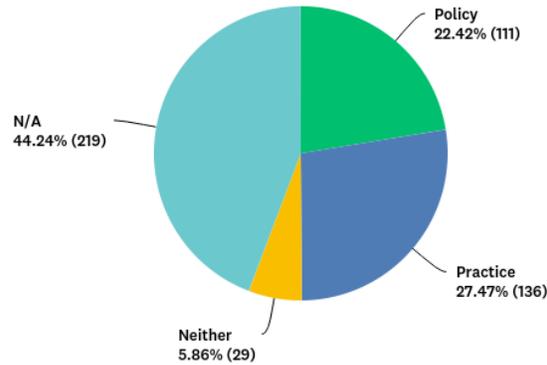
**NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
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Q37 Please indicate whether the firm's investor profile form or questionnaire collects the following data points for customers:

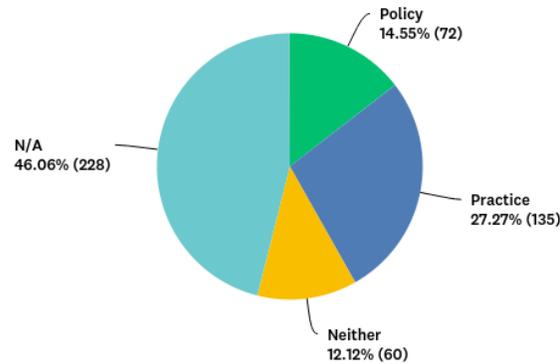


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Q38 In relation to fees charged for various asset classes, please indicate whether it was firm policy or practice to affirmatively discuss costs with customers at the time of the recommendation of whether to buy, hold, or sell a security.

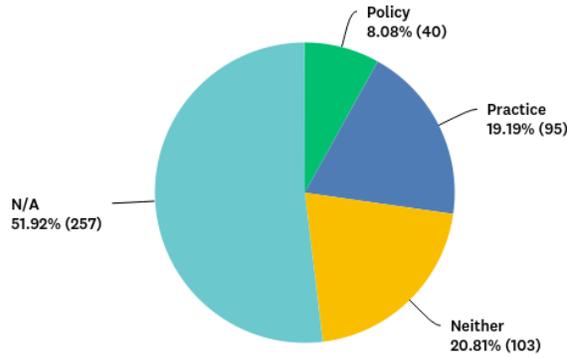


Q39 In relation to the availability of lower-cost, suitable options on the firm's platform, please indicate whether it was firm policy or practice to affirmatively discuss costs with customers at the time of the recommendation of whether to buy, hold, or sell a security.

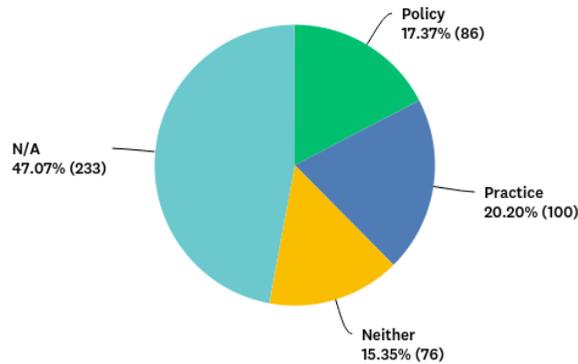


NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
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Q40 In relation to the availability of lower-cost, suitable options outside the firm's platform, please indicate whether it was firm policy or practice to affirmatively discuss costs with customers at the time of the recommendation of whether to buy, hold, or sell a security.

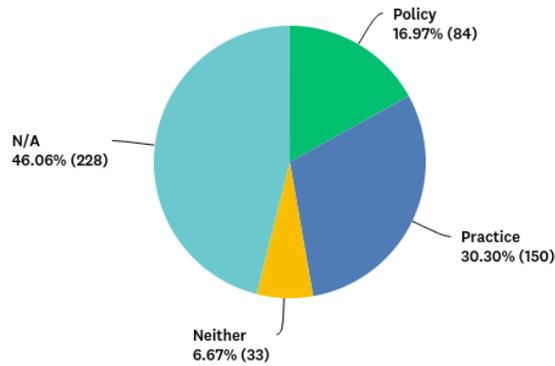


Q41 Disclose or chart out prior to or at account opening the average fees in terms of fixed dollar charge, percentage of assets, or a percentage/dollar range that is typically charged for the recommended account type

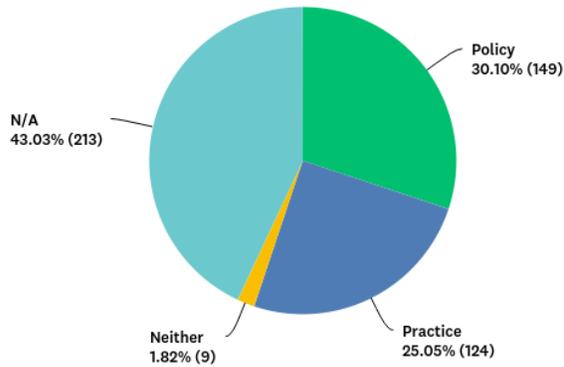


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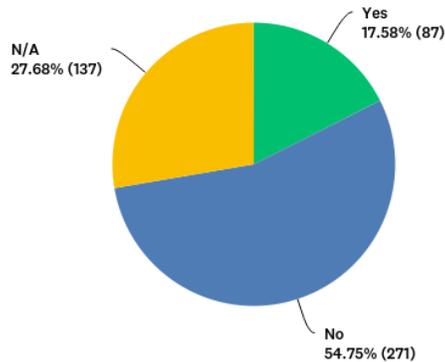
Q42 Educate customers on the pros and cons of selecting competing account types (e.g., brokerage versus an advisory account)



Q43 Educate customers on account recommendations (e.g., rolling over assets from a workplace retirement account to an IRA)

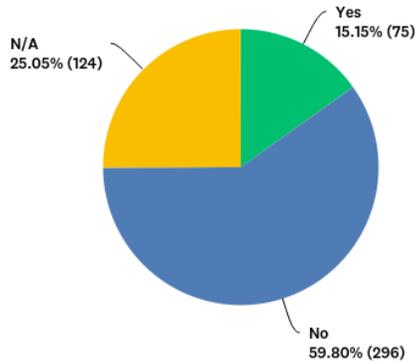


Q44 Accept third-party compensation (cash or non-cash, including gifts of travel or entertainment) from a product manufacturer or sponsor on account of sale/advice to customers

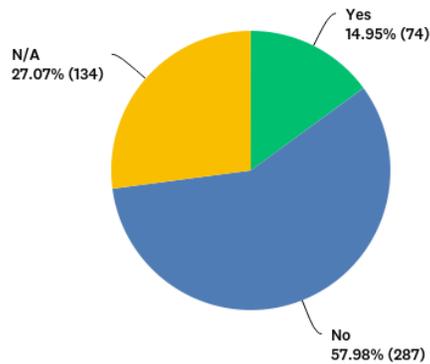


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Q45 Accept third-party compensation (cash or non-cash, including gifts of travel or entertainment) from another broker-dealer, investment adviser, or other financial institution on account of sale/advice to customers

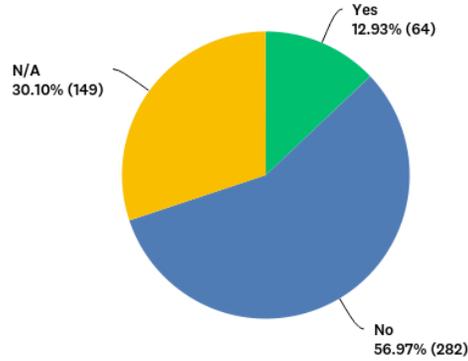


Q46 Accept third-party compensation (cash or non-cash, including gifts of travel or entertainment) from an insurance marketing organization

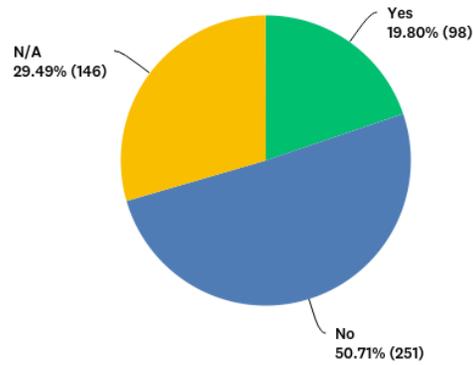


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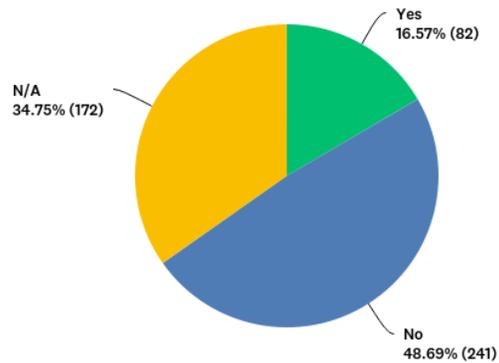
Q48 Agent/rep compensation tied to asset accumulation



Q49 Agent/rep compensation tied to incremental sales growth

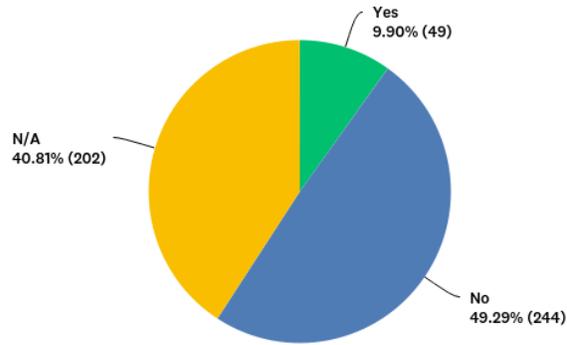


Q52 Allow differential compensation within product family or comparable product lines

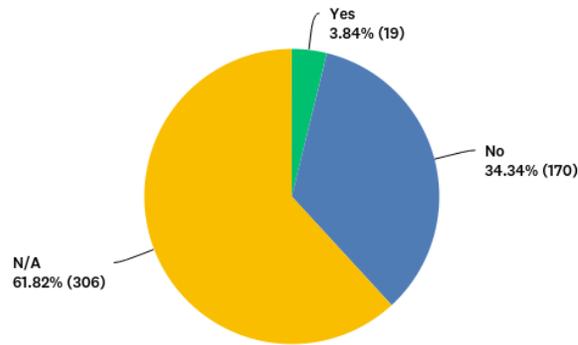


NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
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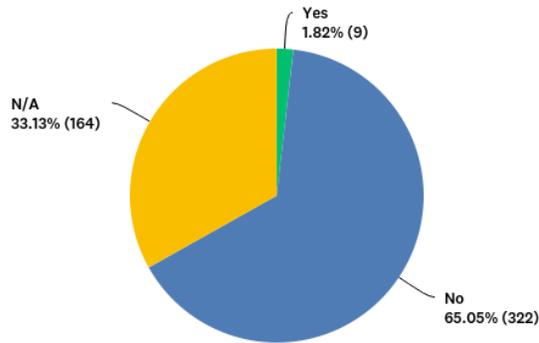
Q53 Cap the compensation or sales credit that an agent/rep receives for sales/advice within product family or comparable product lines



Q54 Neutralize cost to customer where differential compensation is utilized

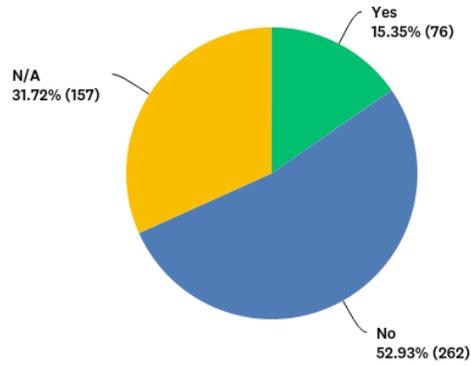


Q55 Utilize product-specific sales contests, quotas, or bonuses to compensate agents/ reps

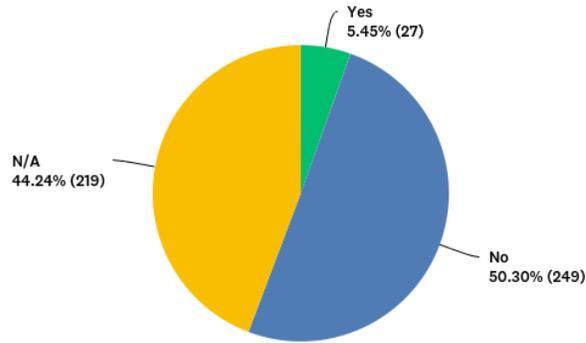


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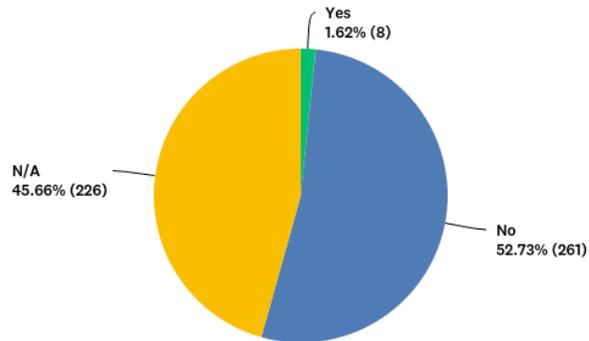
Q56 Utilize sales contests, quotas, or bonuses that are not tied to a specific product to compensate agents/ reps



Q57 Agent/rep compensation tied to sales of a proprietary product

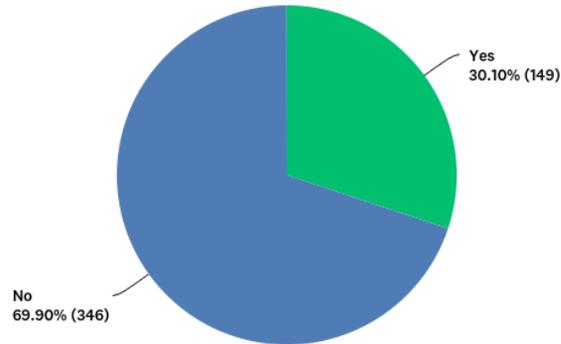


Q58 Utilize sales contests for proprietary product

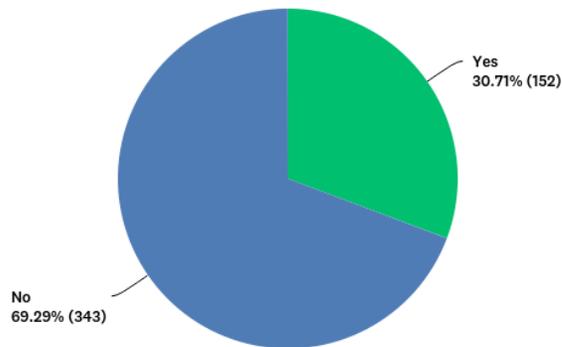


NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
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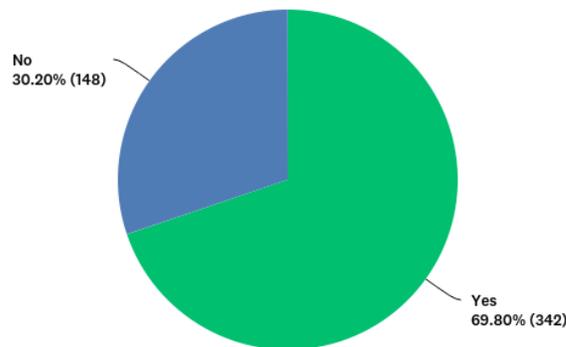
Q60 Please indicate whether the firm has a conflicts of interest register or catalog.



Q61 Please indicate whether the firm has a conflicts of interest committee or a designated conflicts officer.

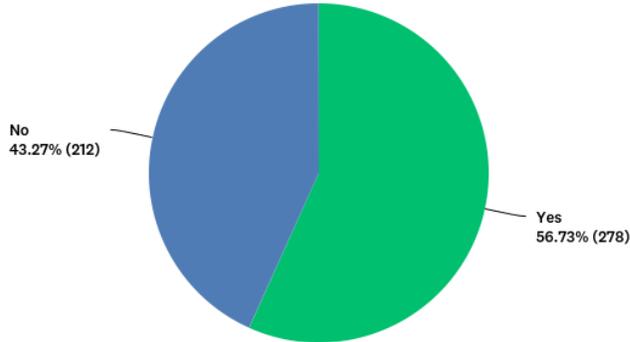


Q62 Investor profile questionnaire forms

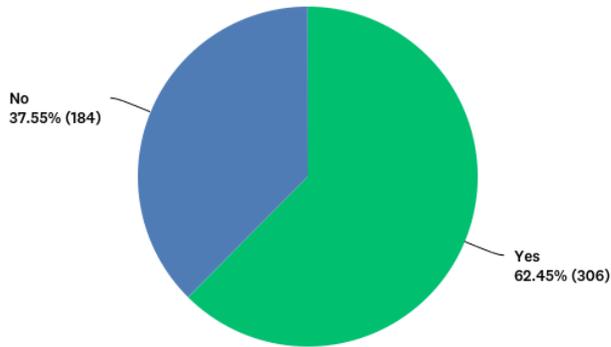


NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020

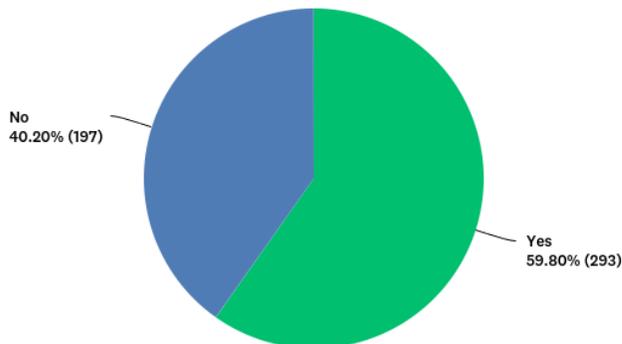
Q63 Conflict of interest policies and procedures



Q64 Suitability/Best Interest/Fiduciary Obligations policies and procedures and applicable questionnaires

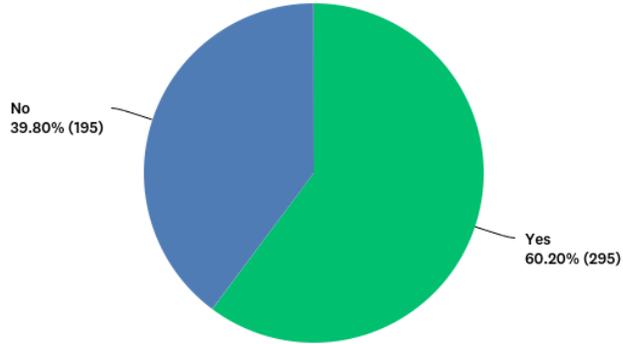


Q65 Policies and procedures related to the disclosure of any fees (e.g., commissions, account fees, etc.)

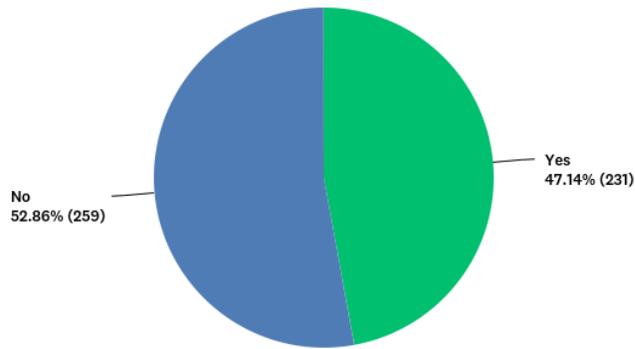


NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020

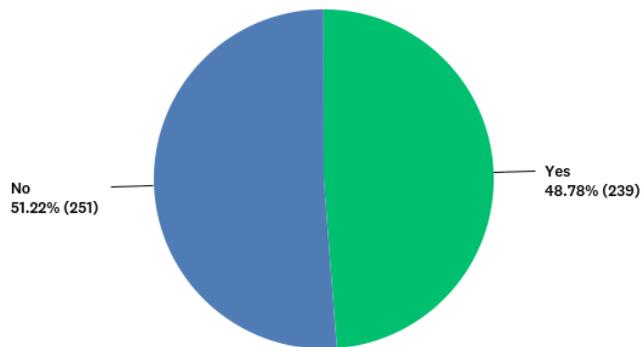
Q66 Product-specific policies and procedures



Q67 Policies and procedures regarding IRA/retirement account rollovers

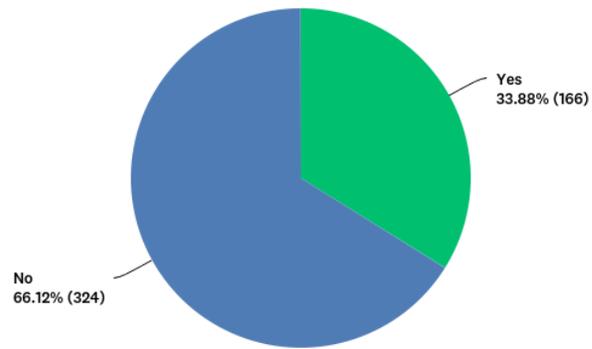


Q68 Share class policies and procedures



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Q69 Cost/product comparison forms or other tools utilized for this purpose



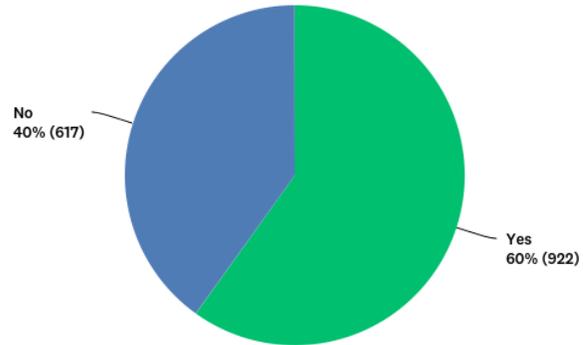
**NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
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**APPENDIX B**

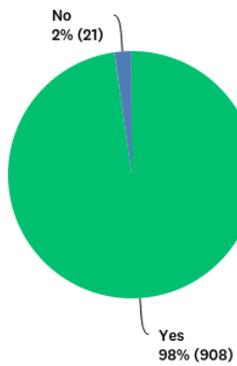
**INVESTMENT ADVISER RESPONSES**

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Q10 Does your firm carry E&O insurance?

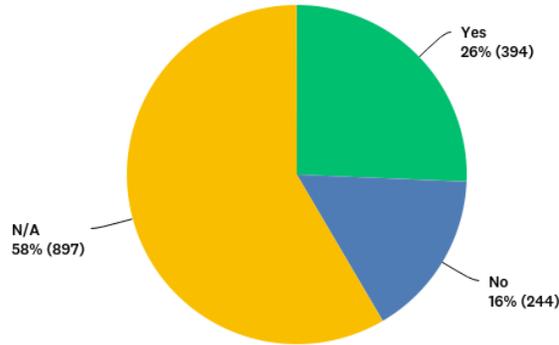


Q13 Does this policy cover all registered persons?



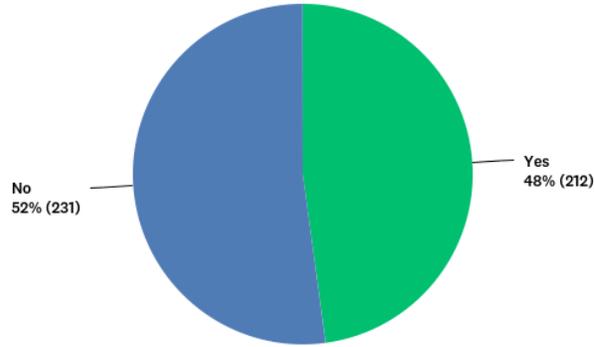
NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020

Q14 Please indicate if the firm or its registered agents/representatives use, or permit the use of, the title of "advisor" or "adviser" in marketing materials, disclosures, customer agreements, websites, or as a job title on business cards or in any form of social media to describe itself or its registered agents/representatives while operating in the capacity of a broker-dealer.

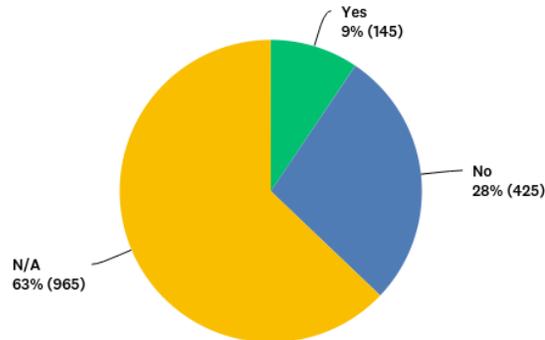


NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020

Q15 Are there any prerequisites for such use as described in the previous question (e.g., dual registration)?

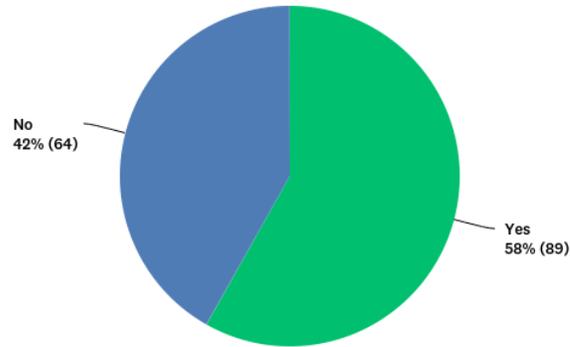


Q16 Please indicate whether the firm or its registered agents/representatives use, or permit the use of, the title of "wealth manager," "financial consultant," or similar title in marketing materials, disclosures, customer agreements, websites, or as a job title on business cards or in any form of social media to describe itself or its employees while operating in the capacity of a broker-dealer.



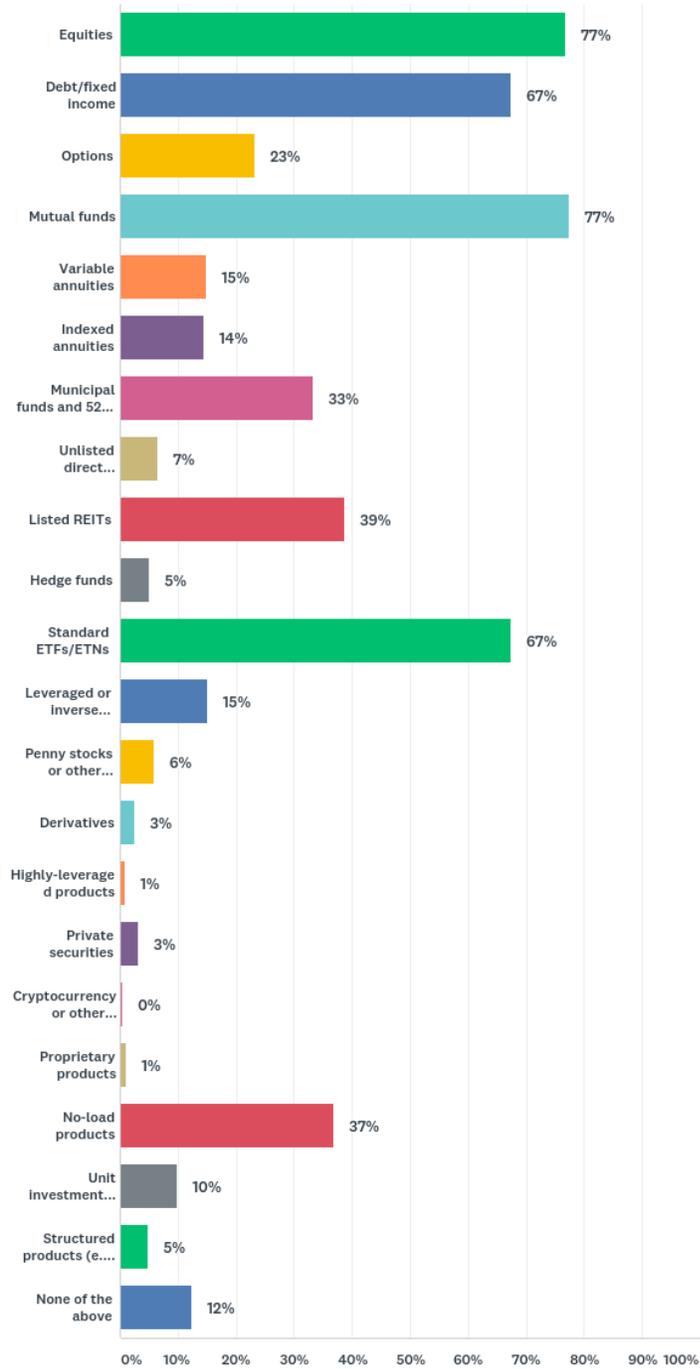
NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020

Q17 Are there prerequisites for such use as described in the previous question (e.g., dual registration)?



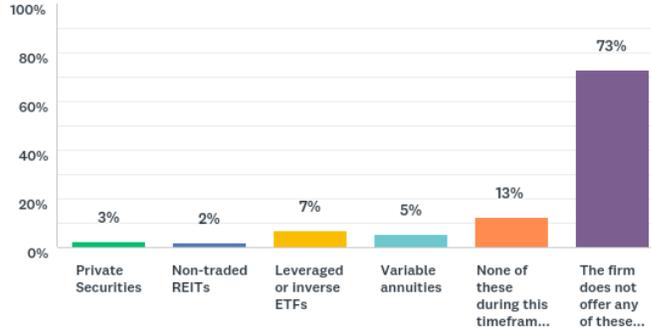
NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
 PHASE I NATIONAL EXAM INITIATIVE 2020

Q18 Products made available by investment advisers:

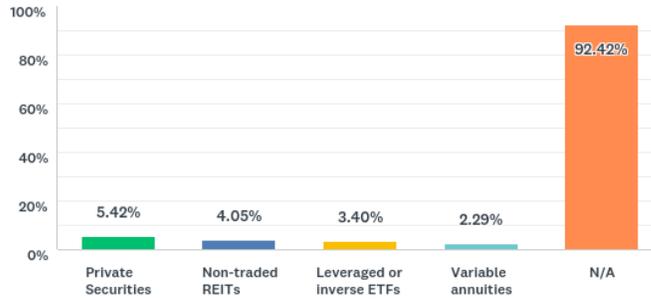


**NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020**

Q19 Did you place customers in any of the following product types? Check all that apply.

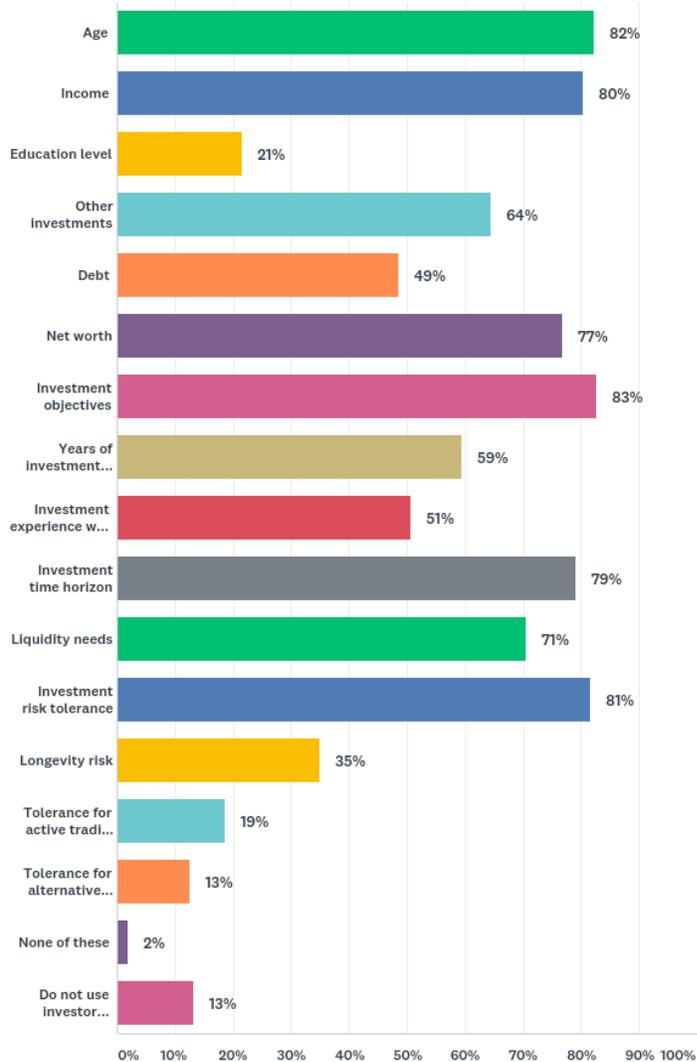


Q20 Are any of the following product types excluded from E&O coverage, if applicable?



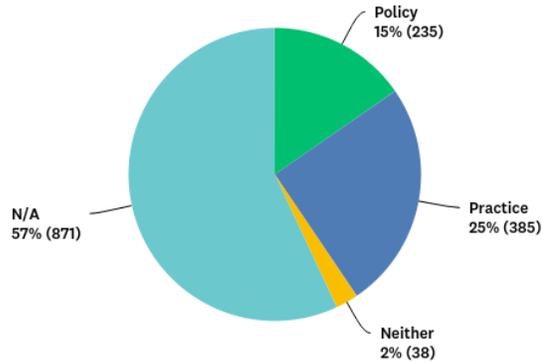
**NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020**

Q37 Please indicate whether the firm's investor profile form or questionnaire collects the following data points for customers:

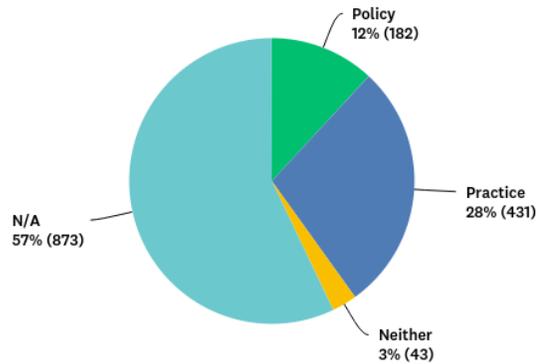


NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020

Q38 In relation to fees charged for various asset classes, please indicate whether it was firm policy or practice to affirmatively discuss costs with customers at the time of the recommendation of whether to buy, hold, or sell a security.

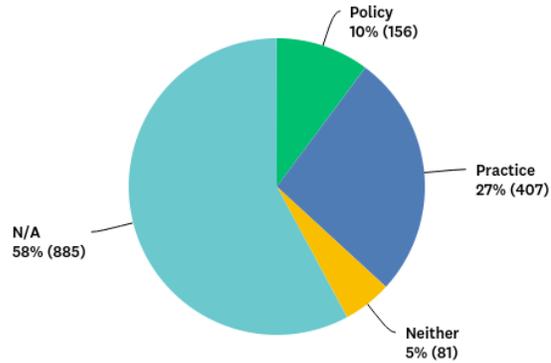


Q39 In relation to the availability of lower-cost, suitable options on the firm's platform, please indicate whether it was firm policy or practice to affirmatively discuss costs with customers at the time of the recommendation of whether to buy, hold, or sell a security.

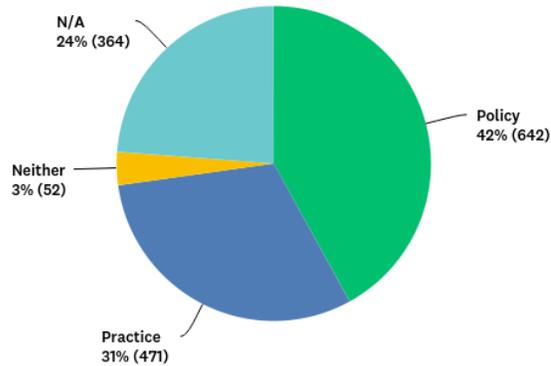


NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020

Q40 In relation to the availability of lower-cost, suitable options outside the firm's platform, please indicate whether it was firm policy or practice to affirmatively discuss costs with customers at the time of the recommendation of whether to buy, hold, or sell a security.

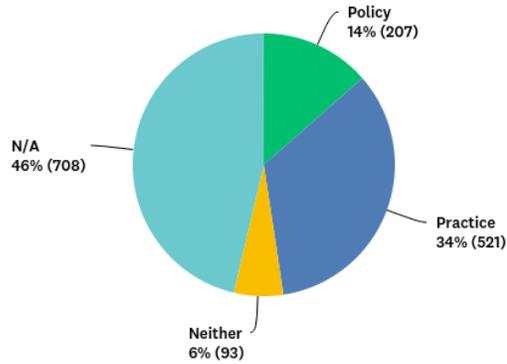


Q41 Disclose or chart out prior to or at account opening the average fees in terms of fixed dollar charge, percentage of assets, or a percentage/dollar range that is typically charged for the recommended account type

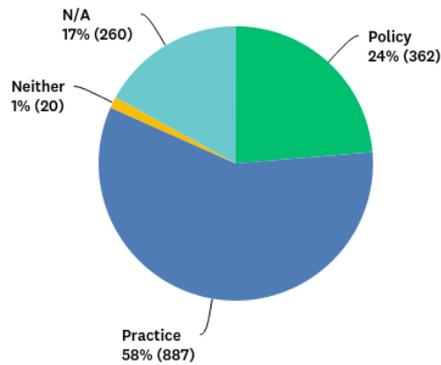


NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020

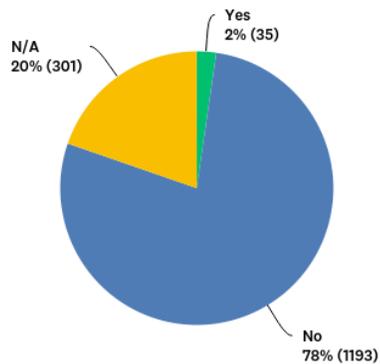
Q42 Educate customers on the pros and cons of selecting competing account types (e.g., brokerage versus an advisory account)



Q43 Educate customers on account recommendations (e.g., rolling over assets from a workplace retirement account to an IRA)

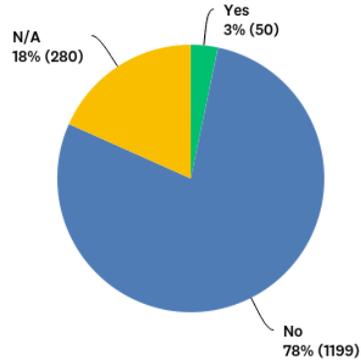


Q44 Accept third-party compensation (cash or non-cash, including gifts of travel or entertainment) from a product manufacturer or sponsor on account of sale/advice to customers

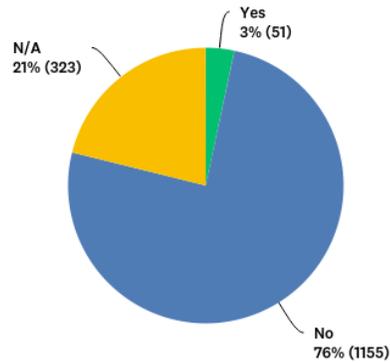


NASAA REGULATION BEST INTEREST IMPLEMENTATION COMMITTEE  
PHASE I NATIONAL EXAM INITIATIVE 2020

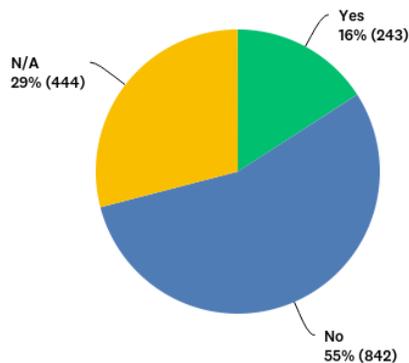
Q45 Accept third-party compensation (cash or non-cash, including gifts of travel or entertainment) from another broker-dealer, investment adviser, or other financial institution on account of sale/advice to customers



Q46 Accept third-party compensation (cash or non-cash, including gifts of travel or entertainment) from an insurance marketing organization

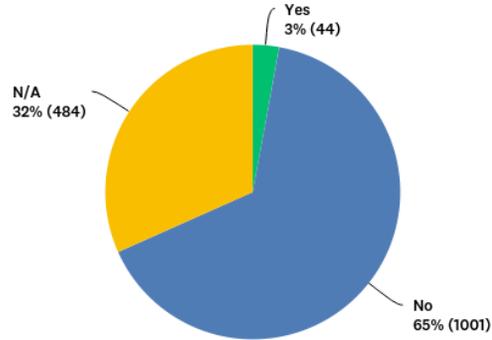


Q48 Agent/rep compensation tied to asset accumulation

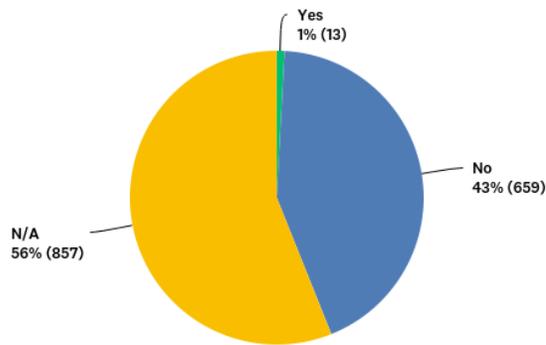


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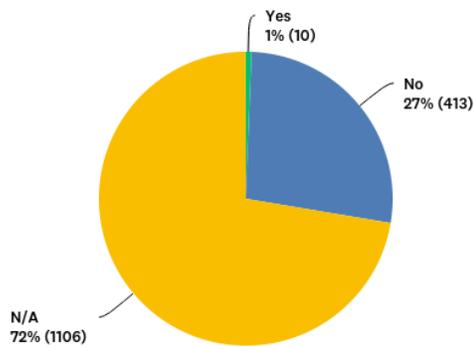
Q49 Agent/rep compensation tied to incremental sales growth



Q53 Cap the compensation or sales credit that an agent/rep receives for sales/advice within product family or comparable product lines

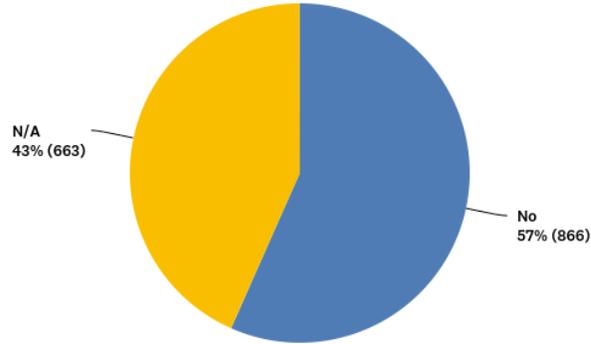


Q54 Neutralize cost to customer where differential compensation is utilized

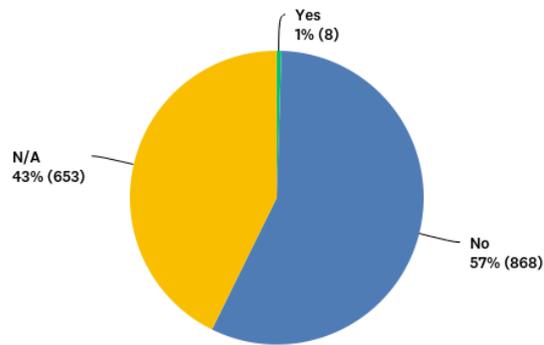


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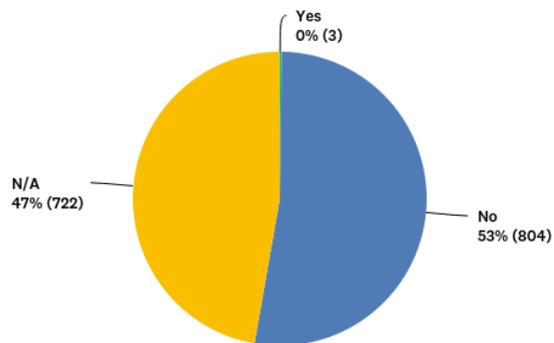
Q55 Utilize product-specific sales contests, quotas, or bonuses to compensate agents/ reps



Q56 Utilize sales contests, quotas, or bonuses that are not tied to a specific product to compensate agents/ reps

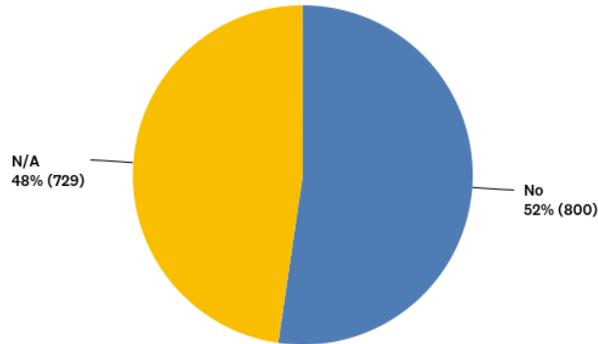


Q57 Agent/rep compensation tied to sales of a proprietary product

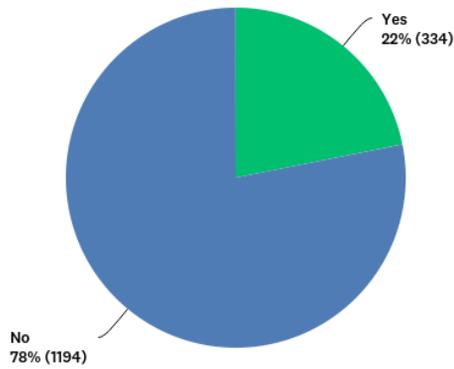


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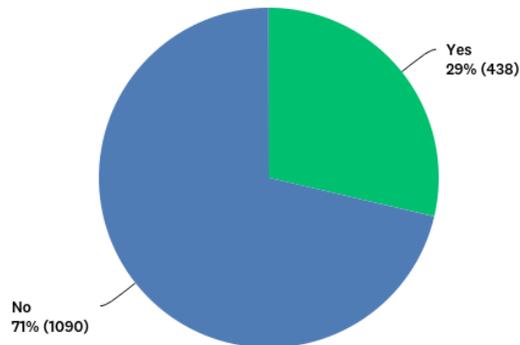
Q58 Utilize sales contests for proprietary product



Q60 Please indicate whether the firm has a conflicts of interest register or catalog.

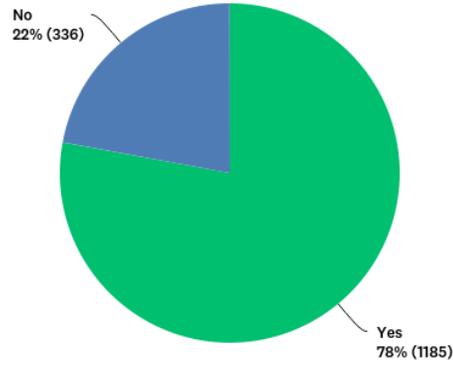


Q61 Please indicate whether the firm has a conflicts of interest committee or a designated conflicts officer.

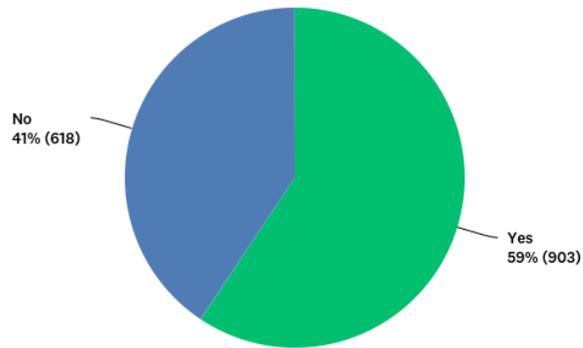


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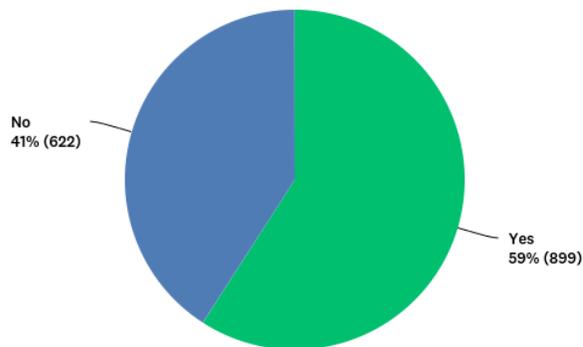
Q62 Investor profile questionnaire forms



Q63 Conflict of interest policies and procedures

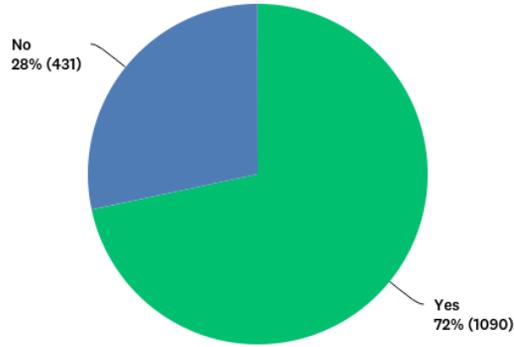


Q64 Suitability/Best Interest/Fiduciary Obligations policies and procedures and applicable questionnaires

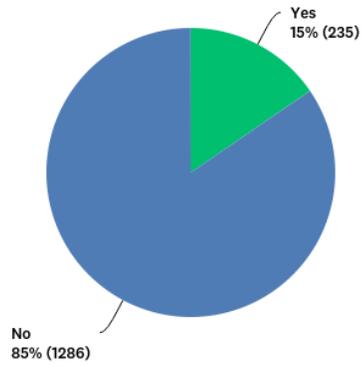


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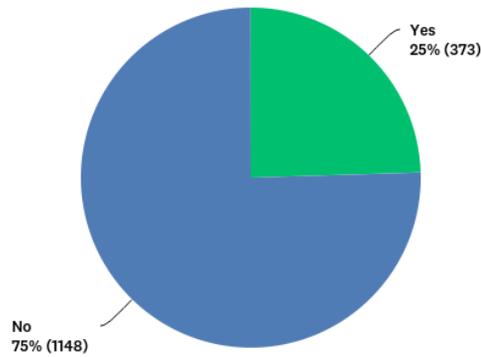
Q65 Policies and procedures related to the disclosure of any fees (e.g., commissions, account fees, etc.)



Q66 Product-specific policies and procedures

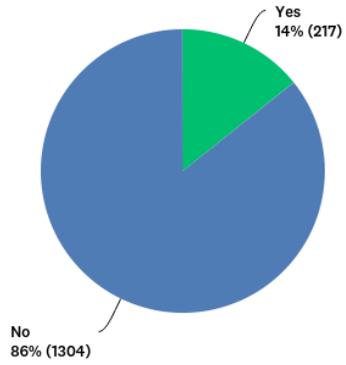


Q67 Policies and procedures regarding IRA/retirement account rollovers

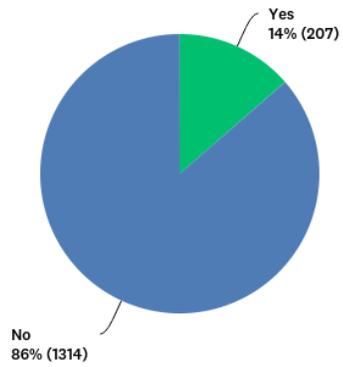


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Q68 Share class policies and procedures



Q69 Cost/product comparison forms or other tools utilized for this purpose



*Adopted by the Executive (EX) Committee and Plenary, Aug. 14, 2020*  
*Adopted by the Executive (EX) Committee, Aug. 13, 2020*  
*Adopted by the Innovation and Technology (EX) Task Force, Aug. 7, 2020*

## National Association of Insurance Commissioners (NAIC) Principles on Artificial Intelligence (AI)

**RECOMMENDS** that insurance companies and all persons or entities facilitating the business of insurance that play an active role in the AI system life cycle, including third parties such as rating, data providers and advisory organizations (hereafter referred to as “AI actors”) promote, consider, monitor and uphold the following principles according to their respective roles; and

**THIS DOCUMENT** is intended to establish consistent high-level guiding principles for AI actors. These principles are guidance and do not carry the weight of law or impose any legal liability. This guidance can serve to inform and establish general expectations for AI actors and systems emphasizing the importance of accountability, compliance, transparency, and safe, secure, fair and robust outputs.

Further, **THIS DOCUMENT**

Should be used to assist regulators and NAIC committees addressing insurance-specific AI applications. The level of regulatory oversight may vary based on the risk and impact to the consumer. These principles should be interpreted and applied in a manner that accommodates the nature and pace of change in the use of AI by the insurance industry and promotes innovation, while protecting the consumer.

### Fair and Ethical

- a. AI actors should respect the rule of law throughout the AI life cycle. This includes, but is not limited to, insurance laws and regulations, such as those relating to trade practices, unfair discrimination, access to insurance, underwriting, privacy, consumer protection and eligibility practices, ratemaking standards, advertising decisions, claims practices, and solvency.
- b. Consistent with the risk-based foundation of insurance, AI actors should proactively engage in responsible stewardship of trustworthy AI in pursuit of beneficial outcomes for consumers and to avoid proxy discrimination against protected classes. AI systems should not be designed to harm or deceive people and should be implemented in a manner that avoids harmful or unintended consequences and corrects and remediates for such consequences when they occur.

## Accountable

- a. AI actors should be accountable for ensuring that AI systems operate in compliance with these principles consistent with the actors' roles, within the appropriate context and evolving technologies. Any AI system should be compliant with legal requirements governing its use of data and algorithms during its phase of the insurance life cycle. Data supporting the final outcome of an AI application should be retained and be able to be produced in accordance with applicable insurance laws and regulations in each jurisdiction. AI actors should be responsible for the creation, implementation and impacts of any AI system, even if the impacts are unintended. AI actors should implement mechanisms and safeguards consistent with the degree and nature of the risks posed by AI to ensure all applicable laws and regulations are followed, including ongoing (human or otherwise) monitoring and, when appropriate, human intervention.

## Compliant

- a. AI actors must have the knowledge and resources in place to comply with all applicable insurance laws and regulations. AI actors must recognize that insurance is primarily regulated by the individual states and territories of the United States as well as by the federal government, and that AI systems must comply with the insurance laws and regulations within each individual jurisdiction. Compliance is required whether the violation is intentional or unintentional. Compliance with legal requirements is an ongoing process. Thus, any AI system that is deployed must be consistent with applicable laws and safeguards against outcomes that are either unfairly discriminatory or otherwise violate legal standards, including privacy and data security laws and regulations.

## Transparent

- a. For the purpose of improving the public's confidence in AI, AI actors should commit to transparency and responsible disclosures regarding AI systems to relevant stakeholders. AI actors must have the ability to protect confidentiality of proprietary algorithms, provided adherence to individual state law and regulations in all states where AI is deployed can be demonstrated. These proactive disclosures include revealing the kind of data being used, the purpose of the data in the AI system and consequences for all stakeholders.
- b. Consistent with applicable laws and regulations, stakeholders (which includes regulators and consumers) should have a way to inquire about, review and seek recourse for AI-driven insurance decisions. This information should be easy-to-understand and describe the factors that lead to the prediction, recommendation or decision. This information may be presented differently and should be appropriate for applicable stakeholders.

## Secure, Safe and Robust

- a. AI systems should be robust, secure and safe throughout the entire life cycle so that in conditions of normal or reasonably foreseeable use, or adverse conditions, they can function in compliance with applicable laws and regulations. To this end, AI actors should ensure a reasonable level of traceability in relation to datasets, processes and decisions made during the AI system life cycle. AI actors should enable analysis of the AI system's outcomes, responses and other insurance-related inquiries, as appropriate in keeping with applicable industry best practices and legal requirements.
- b. AI actors should, based on their roles, the situational context and their ability to act, apply a systematic risk management approach to each phase of the AI system life cycle on a continuous basis to address risks related to AI systems, including privacy, digital security and unfair discrimination as defined by applicable laws and regulations.

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*September 15, 2020*

## **Cybersecurity: Safeguarding Client Accounts against Credential Compromise**

### **I. Introduction**

This Risk Alert highlights “credential stuffing” — a method of cyber-attack to client accounts that uses compromised client login credentials, resulting in the possible loss of customer assets and unauthorized disclosure of sensitive personal information.

The Office of Compliance Inspections and Examinations (“OCIE”) has observed in recent examinations an increase in the number of cyber-attacks against SEC-registered investment advisers (“advisers”) and brokers and dealers (“broker-dealers,” and together with advisers, “registrants” or “firms”) using credential stuffing. Credential stuffing is an automated attack on web-based user accounts as well as direct network login account credentials.<sup>1</sup> Cyber attackers obtain lists of usernames, email addresses, and corresponding passwords from the dark web<sup>2</sup> and then use automated scripts to try the compromised user names and passwords on other websites, such as a registrant’s website, in an attempt to log in and gain unauthorized access to customer accounts.

Credential stuffing is emerging as a more effective way for attackers to gain unauthorized access to customer accounts and/or firm systems than traditional brute force password attacks.<sup>3</sup> When a credential stuffing attack is successful, bad actors can use the access to the customer accounts to gain access to firms’ systems, where they are able to steal assets from customer accounts, access confidential customer information, obtain login credential/website information that they can sell to other bad actors on the dark web, gain access to network and system resources, or monitor and/or take over a customer’s or staff<sup>4</sup> member’s account for other purposes.

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<sup>1</sup> The views expressed herein are those of the staff of OCIE. This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the “SEC” or the “Commission”). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by OCIE staff and is not legal advice.

<sup>2</sup> The “dark web” is a subset of the Internet, oftentimes used anonymously, that can only be accessed using specialized software.

<sup>3</sup> A “brute force” attack is an attempt to guess a password using numerous combinations, such as attempting all of the words in a dictionary.

<sup>4</sup> The term “staff” includes firm employees and contractors.

## II. Summary of Observations

OCIE staff has observed an increase in the frequency of credential stuffing attacks, some of which have resulted in the loss of customer assets and unauthorized access to customer information. The failure to mitigate the risks of credential stuffing proactively significantly increases various risks for firms, including but not limited to financial, regulatory, legal, and reputational risks, as well as, importantly, risks to investors.

Firms' information systems, particularly Internet-facing websites, face an increased risk of a credential stuffing attack. This includes systems hosted by third-party vendors. Firms' Internet-facing websites are vulnerable to attack because they can be used by attackers to initiate transactions or transfer funds from a compromised customer's account. In addition, Personally Identifiable Information (PII) is often available via firms' Internet-facing websites. Obtaining a customer's PII from one firm's website can facilitate an attacker's ability potentially to take over a customer account or attack accounts held by the account owner at other institutions.

Successful attacks occur more often when (1) individuals use the same password or minor variations of the same password for various online accounts, and/or (2) individuals use login usernames that are easily guessed, such as email addresses or full names.

OCIE encourages registrants to consider reviewing and updating their Regulation S-P and Regulation S-ID policies and programs to address the emergent risk of credential stuffing.<sup>5</sup>

## III. Firms' Response to Credential Stuffing

OCIE observed a number of practices that firms have implemented to help protect client accounts, including:

- Policies and Procedures. Periodic review of policies and programs with specific focus on updating password policies to incorporate a recognized password standard<sup>6</sup> requiring strength, length, type, and change of passwords practices that are consistent with industry standards;
- Multi-Factor Authentication ("MFA"). Use of MFA,<sup>7</sup> which employs multiple "verification methods" to authenticate the person seeking to log in to an account. The strength of authentication systems is largely determined by the number of factors

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<sup>5</sup> Regulation S-P requires firms to adopt written policies and procedures that address certain safeguards for the protection of customer records and information. Regulation S-ID prescribes certain requirements for firms to establish identity theft preventions programs. *See generally*, 17 CFR 248.30(a) and 248.201.

<sup>6</sup> *See e.g.*, NIST Information Technology Laboratory- Computer Security Resources Center, SP 800-63-3 Digital Identity Guidelines, available at <https://csrc.nist.gov/publications/detail/sp/800-63/3/final>.

<sup>7</sup> NIST Information Technology Laboratory/Applied Cybersecurity Division, "Back to Basics: Multifactor Authentication (MFA)", available at <https://www.nist.gov/itl/applied-cybersecurity/tig/back-basics-multi-factor-authentication>.

incorporated by the system — the more factors employed, the more robust the authentication system.<sup>8</sup> In this regard, MFA may provide more robust authentication than two or one-factor methods of authentication.

- Properly implemented, MFA can offer one of the best defenses to password-related attacks and significantly decrease the risk of an account takeover.
  - Although the use of MFA can prevent bad actors from successfully logging into a customer’s account or into a system to which a staff member has access, it cannot prevent bad actors from identifying which accounts are valid user accounts on the targeted website.
  - Identified accounts may become the targets of future attacks and information concerning the existence and validity of the accounts may be sold to other bad actors, who may attempt to pass the final MFA verification step through other means, such as phishing emails, online research of targeted individuals, and social engineering;
- Completely Automated Public Turing test to tell Computers and Humans Apart (“CAPTCHA”). To combat automated scripts or bots used in the such attacks, deployment of a CAPTCHA, which requires users to confirm they are not running automated scripts by performing an action to prove they are human (e.g., identifying pictures of a particular object within a grid of pictures or identifying words spoken against a background of other noise);
- Controls to Detect and Prevent.
  - Implementation of controls to detect and prevent credential stuffing attacks. This can include monitoring for a higher-than-usual number of login attempts over a given time period, or a higher-than-usual number of failed logins over a given time period.<sup>9</sup>
    - Firms then use tools to collect information about user devices and create a “fingerprint” for each incoming session. The fingerprint is a combination of parameters such as operating system, language, browser, time zone, user agent, etc. For example, if the same combination of parameters logged in several times in rapid sequence, it is more likely to be a brute force or credential stuffing attack;
  - Use of a Web Application Firewall (“WAF”) that can detect and inhibit credential stuffing attacks;

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<sup>8</sup> See NIST SP 800-63-3, supra note 6.

<sup>9</sup> For example, some firms have implemented account monitoring controls to identify and escalate anomalous activity.

- Offering or enabling additional controls that can prevent damage in the event an account is taken over, such as controls over, or limiting online access to, fund transfers and accessing PII; and,
- Monitoring the Dark Web. Surveillance of the dark web for lists of leaked user IDs and passwords, and performance of tests to evaluate whether current user accounts are susceptible to credential stuffing attacks.

#### **IV. Other Considerations in Preparing for Credential Stuffing Attacks**

As firms prepare for credential stuffing attacks, OCIE staff encourages firms to consider their current practices (e.g., MFA and other practices described above) and any potential limitations of those practices, and to consider whether the firm’s customers and staff are properly informed on how they can better secure their accounts.

##### *Informed Customers*

Most firms require customers and staff to create and use strong passwords. However, the use of passwords is less effective if customers and/or staff re-use passwords from other sites. To be more effective, some firms have informed and encouraged clients and staff to create strong, unique passwords and to change passwords if there are indications that their password has been compromised.<sup>10</sup>

##### *Firm Defenses: Multi-Factor Authentication and the Use of Mobile Phones*

Mobile phone text messages are often used as a verification method for MFA but this method is not foolproof. Mobile phone text messages rely on the use of proper security by mobile phone providers to authenticate account holders properly when transferring phone numbers between devices. Some firms highlight for account owners and staff that they should be alert to instances where their mobile devices no longer work, as someone may have attempted fraudulently to transfer their phone number to another device.

#### **V. Conclusion**

Financial institutions should remain vigilant and proactively address emergent cyber risks. OCIE encourages firms to review their customer account protection safeguards and identity theft prevention programs and consider whether updates to such programs or policies are warranted to address emergent risks. In addition, firms are encouraged to consider outreach to their customers to inform them of actions they may take to protect their financial accounts and personally identifiable information.

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<sup>10</sup> Recent NIST password guidelines note that password changes are not required unless there is evidence that an account has been compromised. See e.g., NIST Special Publication 800-63-B, Digital Identity Guidelines: Authentication and Lifecycle Management, available at <https://pages.nist.gov/800-63-3/sp800-63b.html>.

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*This Risk Alert is intended to highlight for firms risks and issues that OCIE staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.*

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