SUITABILITY OF SALES
OF LIFE INSURANCE
AND ANNUITIES
Suitability Of Sales Of Life Insurance And Annuities

Adopted June 2000

NAIC

National Association Of Insurance Commissioners
TABLE OF CONTENTS

I. Introduction .............................................................................................................. 1
II. Survey Results ......................................................................................................... 1
III. SEC and NASD Suitability Standards and Enforcement Procedures ............... 2
    A. Introduction ........................................................................................................ 2
    B. Background ........................................................................................................ 2
    C. Securities and Exchange Commission Suitability Rules and Enforcement ....... 3
    D. NASD Suitability Requirements ....................................................................... 4
    E. NASD Enforcement Activity ............................................................................. 6
    F. Summary ............................................................................................................ 7
IV. Applicable Case law ............................................................................................... 7
V. State Suitability Statutes and Standards ................................................................. 10
    A. States with Broad Suitability Standards ......................................................... 11
       1. Iowa .............................................................................................................. 11
       2. Kansas ......................................................................................................... 12
       3. Minnesota .................................................................................................... 12
       4. South Dakota ............................................................................................... 13
       5. Vermont ....................................................................................................... 13
       6. Wisconsin ..................................................................................................... 14
    B. Other States with Some Suitability Standards ............................................... 14
       1. New Mexico .................................................................................................. 14
       2. Ohio ............................................................................................................. 14
       3. Utah ............................................................................................................. 15
VI. COMPARISON OF THE INSURANCE AND SECURITIES INDUSTRIES ....... 15
    A. The Products .................................................................................................... 15
    B. The Issuers ...................................................................................................... 16
    C. The Sales Representatives ............................................................................. 16
    D. The Customer ................................................................................................. 16
VII. Current Consumer Protection Tools .................................................................. 17
    A. Standards for Informing and Educating Consumers ........................................ 17
VIII. Voluntary Suitability Standards ....................................................................... 19
    A. Insurance Marketplace Standards Association (IMSA) ................................ 19
    B. Other Voluntary Suitability Measures ............................................................ 21
IX. INDUSTRY VIEWPOINT .................................................................................. 21
X. THE FINANCIAL SERVICES MODERNIZATION ACT .............................. 22
XI. Conclusions and Recommendations ................................................................. 22
    A. Conclusions .................................................................................................... 22
    B. Recommendations .......................................................................................... 23

Appendix A: AMERICAN COUNCIL OF LIFE INSURERS COMMENTS ON WHITE
   PAPER ON SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES .... 25
Appendix B: NATIONAL ALLIANCE OF LIFE COMPANIES COMMENTS ON WHITE
   PAPER ON SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES .... 28
I. INTRODUCTION

The creation of this white paper is the result of a charge assigned to the Life Insurance and Annuities (A) Committee as follows:

"Draft a white paper discussing issues related to suitability of sales of life insurance and annuities. Make recommendations as to the advisability of drafting a model law or regulation giving insurers responsibility to determine suitability of sales of life insurance and annuities."

The charge was precipitated, in large part, by concerns expressed by the members of two working groups, the Replacement Issues Working Group and the Annuities Working Group.

During the development of the new Life Insurance and Annuities Replacement Model Regulation, members of the Replacement Issues Working Group discussed the advisability of incorporating suitability standards for replacement transactions. After considerable discussion, it was agreed that the issues surrounding the development of suitability standards are so complex as to merit separate consideration and that suitability concerns are not limited to replacement transactions. Members of the working group decided to make a recommendation to the Life Insurance and Annuities (A) Committee to form a working group to examine the subject of suitability in the sale of life insurance when work on the new replacement model was completed.

During approximately the same time period, the Annuities Working Group was considering various issues related to the sale of annuities. In the first half of 1997, a survey of the states was conducted to identify annuity-related concerns. Included in the results was a suggestion from 22 states that a model should be developed creating suitability requirements for annuity sales. Like the Replacement Issues Working Group, members of the Annuities Working Group recognized the difficulties associated with developing such suitability requirements. It, too, decided to recommend that the task be assigned by the parent committee to a separate working group.

In an effort to fulfill the charge, this white paper will attempt to examine the issue of the creation and enforcement of suitability standards. It will discuss the suitability requirements established by the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD) for the sale of registered products and the effectiveness of their enforcement of those requirements, including applicable court decisions. Other sections of the white paper will summarize the standards established to date by various states and their experiences enforcing those standards; the other NAIC models that provide a measure of protection and disclosure to assist purchasers of life insurance and annuities to assess the suitability of such products for themselves; and the extent to which the industry has imposed upon itself requirements to sell products that are appropriate to the need of its customers. In developing the information offered and conclusions reached in this white paper, the working group has benefited from presentations and input given by the NASD and various industry representatives.

II. SURVEY RESULTS

In 1997 the Annuities (A) Working Group surveyed the states on a variety of issues related to their laws on annuities. Forty-four states responded to the survey. One of the questions asked was whether the states had standards in place for the suitability of annuity purchases. Three states responded that they had standards in place. One said it had standards only for variable life. Two said they intended to adopt a
law or regulation. Seven states opined that they did not need a law in this area and 22 states said a model law should be developed.

III. SEC AND NASD SUITABILITY STANDARDS AND ENFORCEMENT PROCEDURES

A. Introduction

Although variable life and annuity contracts are issued by insurance companies and subject to state insurance regulation, they also contain investment risks and are therefore required to be registered with the SEC. Producers who sell variable life insurance and variable annuities are also regulated both by the state insurance laws and the SEC. The producers must be licensed with the states in which they sell these products, as well as being affiliated with a member of the NASD and being a registered securities representative with the NASD. Therefore, it appears appropriate to review the requirements of the SEC and the NASD regarding the suitability of sales for securities, which would include these variable products. The purpose of this review is to determine whether the standards should be considered for all life and annuity products and to see if the existing rules for variable life and annuity products are sufficient to protect the buying public.

B. Background

The Securities Act of 1933 is a federal law passed to require disclosure of material information about a security to the investor and to establish a means to prevent misrepresentation, deceit and other fraudulent activities in the sale of securities. The primary means of accomplishing these goals under the law is through the requirement to register offers and sales of securities. When the law was first passed, the Federal Trade Commission was responsible for its administration. Later, the Securities Exchange Act of 1934 created the Securities and Exchange Commission as an independent, nonpartisan regulatory agency of the securities industry. The Commission is comprised of five members appointed by the President for five-year terms. The staff of the Commission administers the federal securities laws and creates rules and regulations necessary to protect investors.

The Exchange Act and subsequent amendments to it require registration with the SEC of:

- national securities exchanges
- brokers and dealers who conduct interstate commerce (a broker is defined as one engaged in the business of effecting transactions in securities for the account of others; a dealer is a person engaged in the business of buying and selling securities for his own account)
- transfer agents
- clearing agents
- government and municipal brokers and dealers
- securities information processors

Each registered exchange is considered by the act to be a self-regulatory organization (SRO). Under the requirements of the law, the SRO must have rules and procedures in place for its members that assure fair and honest dealing with the investors. Member broker-dealers are subject to disciplinary action including fines, suspension and expulsion by the SRO if they violate these rules. The SEC must approve the rules and any amendments made to them. If an exchange disciplines a member, the member has the right to appeal the decision to the SEC.
In 1938, an amendment to the Exchange Act, commonly referred to as the Maloney Act, allowed for the creation of a national securities association to be registered with the SEC. Under Section 15A of the Act, the rules of such an association must be designed to “prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade ... and in general, to protect investors and the public interest ....” Securities Exchange Act of 1934, Section 15A(b)(6). Members of the association who violate the rules are subject to disciplinary actions including fines, censure, suspension, expulsion or limitation of activities and functions. The NASD is the only registered securities association. Its registration was approved in August of 1939.

C. Securities and Exchange Commission Suitability Rules and Enforcement

Although the SEC does not have a specific rule regarding suitability standards in the sales of securities, its Rule 10b-5 (17 C.F.R. Section 240.10b5) states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

a) to employ any device, scheme, or artifice to defraud,

b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Part of the SEC's responsibilities includes overseeing the SROs. Any registered representative who contests a decision rendered by the SRO has the right to appeal it to the SEC. The SEC has upheld SRO disciplinary action where the broker-dealer has been found to recommend securities that are not suitable for the client. In one particular case, In the Matter of the Application of Stephen Thorlief Rangen for Review of Disciplinary Action Taken by the New York Stock Exchange, Inc., Rel. No. 38486, Admin. Proc. File No. 3-8994, April 8, 1997, a broker-agent was disciplined for recommending the purchase of speculative securities on margin to three clients of limited financial means who had indicated they were looking for safe investments with steady income. In upholding the New York Stock Exchange’s findings and sanctions, the Commission stated:

“[W]e find that Rangen’s recommendations to these customers were unsuitable and, therefore, inconsistent with just and equitable principles of trade. Rejlek, Mr. and Mrs. Staples, and F. Staples were all seeking safe, income-producing investments, and did not wish to speculate .... Even if we were to accept Rangen’s view that these clients wanted to speculate and were aware of the risks, a conclusion not supported on this record, the Commission has held on many occasions that the test is not whether Mr. and Mrs. Staples considered the transactions in their account suitable, but whether Rangen ‘fulfilled the obligation he assumed when he undertook to counsel [them], of making only such recommendations as would be consistent with [their] financial situation and needs.’"
In another case an agent was sanctioned by the NASD for making unsuitable recommendations. The agent appealed to the SEC and argued that the customer had refused to supply complete information on financial holdings and he was thus forced to estimate her net worth. The Commission held that the agent “had a duty to proceed with caution; to make recommendations only on the basis of the concrete information that [the customer] did supply and not on the basis of guesswork as to the value of other possible assets.” In re Application of Eugene J. Erdoes, 47 S.E.C. 985, 988 (1983)(emphasis original), aff’d. Federal Securities Law Reports, ¶ 91,652 (9th Cir. 1984). The Commission stated that the test of whether the sales representative’s conduct was proper was not whether the customer thought the transactions were suitable, but rather “whether [the agent] fulfilled the obligation he assumed when he undertook to counsel [the customer], of making only such recommendations as would be consistent with [her] financial situation and needs.” Id. at 989 (quoting Philips & Company, 37 S.E.C. 66, 70 (1956).

It is apparent the SEC places the burden on the broker-dealer to review the information provided by the client regarding income, net worth and investment objectives to determine which securities are suitable.

Because the SEC rules allow for self-regulatory organizations, an important role of the Commission staff is monitoring and oversight of these organizations. The Division of Market Regulation completes inspections of the SROs, reviewing their market surveillance and disciplinary programs and procedures for handling customer complaints as well as other financial and operational procedures. The Division of Investment Management reviews registration statements and recommends rules. Part of its job also involves issuing interpretive letters relating to variable annuity and variable life insurance products registered with the SEC. The Office of Compliance Inspections and Examinations examines SROs to determine if they are acting in accordance with securities laws. As a result of the rapid growth in the variable insurance products market, the office formed a specialized insurance product examination team. The SEC’s 1997 Annual Report states this team examined 24 insurance companies representing 20% of the insurance sponsors for variable insurance products. In 20 of these exams, deficiency notices were issued.

D. NASD Suitability Requirements

The NASD is a self-regulatory organization with over 500,000 registered securities representatives, 5,400 securities firms and 58,000 branch offices as members. In 1996, as part of a restructuring of the organization, NASD Regulation, Inc. was established as an independent subsidiary of NASD responsible for regulating the securities market. All securities professionals associated with a member firm must register with the NASD.

NASD Manual and Notices to Members Conduct Rules, Section 2310 addresses suitability requirements:

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

In 1990 the rule was amended to add the following requirements for accounts opened and recommendations made after January 1, 1991:
Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

(1) the customer’s financial status;
(2) the customer’s tax status;
(3) the customer’s investment objectives; and
(4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

The subject of suitability has been addressed in several notices to its members written by the NASD in the past few years. For example, NASD Notice to Members 95-80 reminds members that “A starting point in a member’s recommendation of a mutual fund is to clearly define the investor’s objectives and financial situation. The need for current income, liquidity, diversification, and acceptable levels of risk are important considerations.”

The NASD has also expressed concern about the suitability of certain sales of variable life insurance products. NASD Notice to Members 96-86 reminded members that Rule 2310 applies to the sale of these variable products since they are registered securities. Members were advised that a representative was recently fined $75,000 and disciplined by NASD Regulation because it was determined, based upon facts disclosed to him about financial situation, needs and investment objectives, that he did not have reasonable grounds for recommending the sale of certain variable life insurance products to several customers. The notice listed some factors regarding a recommendation to purchase variable products that could be considered under the suitability rules including:

(i) a representation by the customer that his or her life insurance needs were already adequately met;
(ii) the customer’s express preference for an investment other than an insurance product;
(iii) the customer’s inability to fully appreciate how much of the purchase payment or premium is allocated to cover insurance or other costs, and a customer’s ability to understand the complexity of variable products generally;
(iv) the customer’s willingness to invest a set amount on a yearly basis;
(v) the customer’s need for liquidity and short-term investment;
(vi) the customer’s immediate need for retirement income;
(vii) the customer’s investment sophistication and whether he or she is able to monitor the investment experience of the separate account.

In May 1999 NASD Notice to Members 99-35 was issued, reminding members of their responsibilities regarding the sale of variable annuities. The Notice provided recommended guidelines for establishing procedures for the sale of variable annuities that would assist in assuring compliance with both regulatory and legal requirements. Included in the guidelines were such items as making reasonable efforts to obtain comprehensive information about the customer including age, income, risk tolerance, tax status and investment objectives; discussing liquidity issues such as fees, penalty charges, taxes and administrative charges; making sure the registered representative has a thorough knowledge of the recommended variable annuity including the death benefits, tax treatment and subaccount choices; and providing, whenever practical, a current prospectus on the variable annuity to the customer. The notice
also cautions members that in most cases variable annuities are not suitable for customers with short term investment objectives, and that in some cases, those of advanced age may not be suitable for a variable annuity.

The NASD views suitability requirements as part of the overall requirement of fair dealing with customers. NASD Conduct Rule IM 2310.2 requires members and registered representatives to observe sales practices which are within the ethical standards of the association and which deal fairly with the public. Replacement of existing securities primarily to generate new commissions, excessive trading and selling products beyond the customer’s financial ability to pay are all actions which would be considered in violation of the Rules of Conduct.

E. NASD Enforcement Activity

The two major tools that NASD Regulation uses to discover violations of suitability rules are field examinations and investigations of complaints. Member firms are examined anywhere from once a year to once every four years, with sales practices a major part of a routine exam. In addition, the Association investigates individual complaints filed against member firms and registered representatives. Disciplinary action is primarily used to promote industry compliance with the Rules of Conduct, rather than as a source of relief or recovery to the complainant.

Once an investigation is complete, the staff must determine if formal disciplinary action is warranted. Cases where formal action is recommended must be reviewed and authorized by the Office of Disciplinary Affairs. (Prior to January 1, 1999 the Case Authorization Unit and Office of Disciplinary Policy reviewed and commented on these cases. NASD Notice to Members 99-01 placed the functions performed by both these units into the Office of Disciplinary Affairs.) The Office of Disciplinary Affairs reviews the “legal, policy and consistency issues presented by each case.” NASD Notice to Members 99-01 If formal action is warranted, NASD issues a complaint and the respondent must respond or request an extension within 25 days. Hearings are conducted through the Office of Hearing Officers with a decision rendered in writing by the assigned hearing officer. Both the respondent and the Enforcement Department have the right to appeal the decision to the National Adjudicatory Council (NAC).

To understand how the NASD interprets suitability guidelines, it is helpful to look at findings from hearings. In the Matter of District Business Conduct Committee for District No. 8 v. Miguel Angel Cruz was decided by the National Business Conduct Committee of NASD Regulation, Inc. on October 31, 1997. A major portion of the decision centered around an examination of the evidence presented in the sale of variable life insurance products to nine customers. In each case, the committee reviewed the stated investment objectives and goals of the customers to determine whether the product was suitable to meet these objectives. In one case the customer told Cruz she wanted to invest money and she also needed more insurance. She was interested in products with tax-deferred features. While this customer was not happy with the performance of the product and believed she was going to get less insurance and more investment for the premiums, there was no evidence that information was not disclosed to her and the committee determined the variable life product was not unsuitable for her stated investment goals. Another customer specifically told Cruz he has no interest in life insurance since he already had sufficient coverage. He was looking for an investment vehicle to save money for his retirement. In this case, given the stated investment objectives, the committee found the policy to be unsuitable. Each of the nine sales was reviewed in this manner and the representative was fined, received a censure and was required to requalify as an investment company and variable contracts representative.
Although misrepresentation is a separate violation of the Rules of Conduct, it is not uncommon for a representative to misrepresent a product that is not suitable for the stated investment objectives. In the 
Cruz case, when the customers indicated their objectives were to invest money for short time periods and that they had no interest in insurance, Cruz represented the variable life policy as primarily an investment product with incidental life insurance. He failed to disclose substantial penalty charges for early surrender of the product. In reviewing the investment objectives and the true nature of the product, it is apparent the customers would have concluded on their own that the product was unsuitable if all features were truly represented.

F. Summary

The NASD and other self-regulatory organizations that are regulated by the SEC have specific rules that address the suitability requirements for investments. Knowledge of the investor's financial status, tax status and investment objectives are important factors that must be considered prior to recommending a product. Representatives are expected to make reasonable efforts to obtain this knowledge and only make recommendations that are consistent with the investor's tax status, financial status, investment objectives and other characteristics of the investor as expressed or apparent to the representative. The SEC addresses suitability under its fraud and misrepresentation rules. Suitability concerns are seen as part of the overall requirements of fair dealings expected of a representative. Registered firms and representatives who violate SRO or SEC rules are subject to disciplinary action including fines, suspensions of their registration and civil or criminal action.

IV. APPLICABLE CASE LAW

This section provides an overview of how suitability standards have been applied by courts and regulatory bodies, generally in relation to cases involving the suitability of securities transactions.

Most discussion by courts of what "suitability" means arises out of cases interpreting the NASD rules. The suitability rule is just one part of the NASD Rules of Fair Practice. For example, the NASD Rules of Fair Practice also require NASD members to "observe high standards of commercial honor and just and equitable principles of trade." Article III Section 1 of NASD Rules of Fair Practice (NASD Manual). The NASD Rules of Fair Practice are closely related to and often applied at the same time as federal securities laws.

As part of understanding the reasons the courts have interpreted "suitability" as they have, it is helpful to know the background for the duties imposed upon persons selling securities.

A theory that is often discussed in securities sales practice cases is the "shingle" theory. The theory comes from a 1939 Commission administrative proceeding and, therefore, predates Section 10b-5. Under the "shingle" theory, the act of "hanging out a shingle" is an implied representation that a person will be fair with customers. 5C Litigation and Practice Under Rule 10b-5, § 211.03, 9-12 and 9-13 (1994).

Inherent in the relationship between a dealer and his customer is the vital representation that the customer will be dealt with fairly and in accordance with the standards of the profession. It is [not] fair dealing...to exploit trust and ignorance for profit far higher than might be realized from an informed customer.

Id. (quoting 6 SEC at 388-89 (footnote omitted)).
The courts have routinely held that a securities agent occupies a special status with a customer. "A securities dealer occupies a special relationship to a buyer of securities in that by his position he implicitly represents he has an adequate basis for the opinions he renders." *Hanly v. Securities & Exch. Comm'n*, 415 F.2d 589, 596 (2d Cir.1969).

This special status imposes certain duties on securities dealers:

In summary, the standards by which the activities of each petitioner must be judged are strict. He cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation.

*Hanly, supra*, at 597.

One author has stated:

The theory on which any doctrine of suitability must rest...is that the customers tend to rely on their broker-dealer. [T]he broker-dealer community has made the investing public aware that it has the special skills needed to deal with such intricate merchandise as securities, and the public has been encouraged to—and has—relied on the superior skill of the broker-dealer community in its securities transactions.


The purpose of the suitability rule is not to make a broker-dealer an insurer of favorable investment performance or to review a broker-dealer's investment judgment. *Id.* at 448. Imposing a suitability standard "shifts the responsibility for making trustworthy investment decisions from the customer to the broker-dealer." *Id.,* at 449. "A suitability doctrine imposes a responsibility on the broker-dealer to take the risk threshold of his customers into account when he recommends or sells securities to them." *Id.*

The term "suitability" has been defined in case law as follows:

- "adapted, appropriate, apt, fit, proper" (40A Words and Phrases 189).
- "'Suitable' is defined as appropriate and fitting." (*Id.,* at 96, *citing Morgan v. Morgan*, 366 N.Y.S. 2d 977, 981, 81 Misc. 2d 616 (1975)).

How does one determine whether a recommendation was suitable? An analysis often applied by the courts in investment sales practice cases is whether a reasonable basis existed for the transaction. Under
a reasonable basis rule, “[a] brokerage firm’s recommendation to purchase or sell a security carries with it the implied representations that there is a reasonable basis for the recommendation and that the security is suitable for the customer.” 5C Litigation and Practice Under Rule 10b-5, supra, at Section 211.01, p. 9-23.

Under the “reasonable basis” rule, a broker-dealer has a burden and has certain duties. The burden has been stated as follows: “The SEC rules on reasonable basis place a burden on the broker-dealer to disclose all relevant facts, to make a reasonable investigation into the product recommended and, if the agent lacks knowledge, to disclose the lack of knowledge and caution customers as to the risk.” 5C Litigation & Practice, supra, § 211.01[a], 9-26. The duties have been defined as follows:

[The law implies three separate duties under the reasonable basis rules: (1) to make a reasonable investigation of the facts, which in turn mandates gathering and evaluating the facts in a reasonable manner; (2) to disclose a lack of knowledge regarding the matter; and (3) to reveal known data which show that a statement is wrong.

5C Litigation & Practice, supra, § 211.01[a], 9-55.

A reasonable basis is not always required. “[A] broker has no reasonable basis duties when a customer places an unsolicited order.” 5C Litigation & Practice, supra, § 211.01[a], 9-35 (citing Pachter v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 444 F. Supp. 417, 421-22 (E.D.N.Y. 1978)).

But it is rare that a suitability requirement is not imposed, even with mitigating circumstances. For example, the Hanly court stated that the suitability requirements also must be met when an investor has investment experience. “The fact that his customers may be sophisticated and knowledgeable does not warrant a less stringent standard.” Hanly, supra, at 596 (citations omitted).

The duties and burdens are placed on the seller of securities. The Hanly court also imposed a requirement that agents must not accept at face value information provided by an issuer of a security. “A salesman may not rely blindly upon the issuer for information concerning a company, although the degree of independent investigation which must be made by a securities dealer will vary in each case.” Hanly, supra, at 597.

Several states have gone so far as to impose a fiduciary duty on stockbrokers.

- **California:** California imposes a fiduciary duty on stockbrokers and has rejected arguments that sophisticated investors are owed a lesser standard. See Duffy v. Cavalier, 264 Cal. Rptr. 740 (1989) citing Twomey v. Mitchum Jones & Templeton, Inc., 262 Cal. App. 2d 690 (1968).

- **Missouri:** “Missouri courts have uniformly held or stated that a stockbroker owes a fiduciary duty to his customer.” Vogel v. A.G. Edwards & Sons, Inc., 801 S.W.2d 746, 751 (Mo. App. 1990).


Indeed, there are only a minimal number of duties imposed on the investor. For example, an investor does have an obligation to learn about securities products. “An investor may not justifiably rely on a
misrepresentation if, through minimal diligence, the investor should have discovered the truth.” Brown, supra, at 1032 (citations omitted), Royal American Managers, Inc. v. IRC Holding Corp., 885 F.2d 1011, 1015-16, 2d Cir. (1989).

It is clear that various courts have determined, in reviewing investment sales, that these suitability standard are not wholly unreasonable. It is, however, important to note that the imposition of suitability standard is not a guarantee of future results. In evaluating whether a transaction is suitable, it is improper to evaluate this transaction in light of current events, changes in the economy or a customer’s personal financial situation. A broker is required to simply compare the customer with the security before making a recommendation. See 5C Litigation & Practice, supra, § 211.01[b], 9-63, 64. Suitable investments to meet an investor’s objectives do not guarantee positive financial growth. A broker may recommend or purchase securities that are suitable, but for reasons beyond the broker’s control, the investments do not yield positive results. The failure to achieve positive results does not necessarily make the sale unsuitable. The broker is required to not knowingly make an untrue statement of material fact or knowingly fail to state a material fact that would be relied on by the investor. Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982, 986 (10th Cir. 1992).

In fact, in the opinion of one author, the existence of the suitability requirement can also work to the broker-dealer’s advantage.

Moreover, insofar as it [the suitability doctrine] encourages the broker-dealer to discuss transactions with his customers—particularly to point out the risks of an investment and relate those risks to the customer’s ability to bear them—the suitability doctrine prepares a customer to accept some of the disappointments which inevitably occur in connection with investments in securities.

Mundheim, supra, at 459.

Courts have found a sale of securities to be unsuitable when a broker failed to tell a customer the rating on the debentures sold and the extent of the risk faced. See, e.g., Clark v. John Lamula Investors, Inc., 583 F.2d 594, 598 (2d Cir. 1978). In the Clark case, the sale was found to be unsuitable even though no untrue statements were made. The jury found that the salesman acted with intent to deceive when he failed to inform the buyer of other investment opportunities and charged an excessive price. Id.

Although most cases dealing with the issue of suitability have been securities cases, at least one court imposed a suitability standard on a sale of life insurance as early as 1958. On appeal the court upheld a verdict against the insurance agent and stated “any insurance agent who would sell a man with ... limited income and prospects an insurance program that involved saddling him with a bank indebtedness of $125,000, an essentially term insurance type of protection, and dissipation of the accumulated cash values of his old insurance, must have known that he was not acting honestly in making the sale.” Anderson v. Knox, 297 F.2d 702, 727-28 (9th Cir. 1961) cert. denied, 370 U.S. 915 (1962)

In conclusion, this is not an exhaustive study of the concept of suitability as used in the securities industry. It is meant to serve as an overview and a summary of the key concepts.

V. STATE SUITABILITY STATUTES AND STANDARDS

There are at least six states (Iowa, Kansas, Minnesota, South Dakota, Vermont, Wisconsin) that have a suitability standard for individual life and annuity products, and in some cases, for additional products as well. For each of these states, the following cites the relevant statute or rule, quotes the key operative
language, identifies what products are covered, and highlights any fleshing out of the term “suitability.” Also included is a brief discussion of four other states (Arkansas, New Mexico, Ohio, Utah) that have more limited suitability standards.

A. States with Broad Suitability Standards

1. Iowa

Iowa has an administrative rule (§ 191-15.8) providing that a producer shall not recommend a product without reasonable grounds to believe that the transaction or recommendation is not unsuitable for the person. The rule applies to “the purchase, sale, or exchange of any life insurance policy, annuity, or any rider, endorsement or amendment thereto.” The rule provides some guidance on how to judge suitability, stating that it should be “based upon reasonable inquiry concerning the person’s insurance objectives, financial situation and needs, age and other relevant information known by the producer.” Group products are covered, and the rule specifies that the relevant person in such cases is the group policyowner.

A second rule (§ 191-15.11) provides an exception to a general prohibition on income discrimination when applying suitability standards.

The Iowa rule was adopted with a February 1997 effective date to respond to cases in which consumers complained about sales that were not to their benefit, but who could not prove misrepresentation or any other violation of law in the sales process. The Iowa Insurance Department decided that an additional enforcement tool was necessary and has found its suitability rule to be effective in cases where transactions do not appear appropriate, but where there is no particular evidence of misrepresentation and the paperwork on file with the company would indicate that the transaction was done with the consumer’s consent.

The rule has been used both in resolving consumer complaints and in enforcement actions. Here are examples:

- An 85-year old woman, with a $12,000 annual income, was sold an annuity for $16,000 and life insurance with total face amounts of $17,000 and annual premiums of $3,900. The consumer, who was alleged to suffer from Alzheimer’s disease, was left with current income insufficient to pay premiums and high surrender charges on withdrawals from her annuity. After hearing, the sales were found unsuitable and a civil penalty was assessed against the agent.

- A 69-year old consumer with a terminal illness was sold a replacement annuity that had to be held at least 2.5 years to break even on the surrender charge. The two companies involved agreed to reinstate the original annuity and give a refund on the new one. The agent stipulated to a civil penalty and two years of probation.

- A husband and wife in their fifties were convinced to surrender two life insurance policies in a § 1035 exchange and replace them with a new policy that had $16,000 in surrender charges on the first $25,000 in premium. The new policy also paid less interest and had other unfavorable features compared to original policies. The agent stipulated to a civil penalty and two years probation, and the company agreed to a new contract that made the couple whole.
Based on these cases, the Iowa Department describes its suitability rule as “an additional and valuable tool to use to assist consumers in receiving fair treatment from insurers and insurance producers.” The Department also points out that company oversight alone is not sufficient to detect whether single policies are unsuitable given the potential for agents to sell policies from multiple companies in order to avoid detection. This makes it important for a suitability standard to be applicable against both companies and agents.

2. Kansas

Kansas has an administrative rule (§ 40-2-14(c)(5)) that prohibits recommending to a prospective purchaser the purchase of a product “with reasonable grounds to believe that the recommendation is unsuitable for the applicant.” The rule applies to the purchase or replacement of any life insurance policy or annuity contract. The rule provides limited guidance on how to judge suitability, stating that it should be “on the basis of information furnished by this person, or otherwise obtained.”

One of the many tools at the disposal of the Kansas Insurance Department to curb deceptive practices in the sale of insurance and annuity products is the suitability standard. A recommendation to purchase or replace a policy that an agent believes is “unsuitable for the applicant based on information furnished by this person, or otherwise obtained” is deemed as an unfair or deceptive practice under the unfair trade practices act. This is one of many prohibitions in the Kansas regulations including misrepresentation, false, deceptive or misleading statements and fraud. These, along with the suitability standard, are used by the Kansas Department to judge the treatment of insurance consumers by agents and companies.

3. Minnesota

Minnesota has a statute (§ 60K.14) providing that an agent must have reasonable grounds for believing the recommendation to purchase a product is suitable for the customer. The statute applies to any life, endowment, individual accident and sickness, long-term care, annuity, life-endowment or Medicare supplement insurance.

The statute provides more detail on how to judge suitability, stating that the agent “must make reasonable inquiries to determine suitability” and prescribing the following suitability standard: “the suitability of a recommended purchase of insurance will be determined by reference to the totality of the particular customer’s circumstances, including, but not limited to, the customer’s income, the customer’s need for insurance, and the values, benefits and costs of the customer’s existing insurance program, if any, when compared to the values, benefits and costs of the recommended policy or policies.”

A second statute (§ 72A.20) establishes the same “reasonable grounds for believing that the recommendation is suitable” standard on an insurer “either directly or through its agent.”

The Minnesota Department describes its suitability standard as “an important regulatory tool” and emphasizes that it should not be used simply as a deterrent, but also to clarify guidelines and expectations for insurers and agents. The Department also points out that the ongoing melding of the financial services industry, which is blurring the distinctions between the banking, securities and insurance industries, makes a suitability standard appropriate in the regulation of sales conduct whether the product is a stock, insurance policy or loan.
Minnesota found its suitability standard to be especially helpful when the Department had a number of problems with the unscrupulous sale of multiple Medicare supplement policies to the elderly in the 1980s. It is also helpful in addressing replacement policies where the consumer may be giving up important benefits such as the two-year limit on contestability. A suitability standard also encourages agents to scrutinize advantages and disadvantages involves the comparison of surrender charges on the existing and new policies.

4. South Dakota

South Dakota has adopted rules (§ 20:06:14:03(7)) governing the suitability of individual life and both individual and group health that generally require that the agent determine the appropriateness of the sale by examining the totality of the consumer’s circumstances including their financial condition and need for insurance at the time. South Dakota also has a statute (§ 58-17-87) authorizing rules on the “suitability and appropriateness” of individual health benefit plans, and a second statute (§ 58-18B-35) authorizing rules on the “suitability and eligibility for coverage of insureds” for stop loss, multiple employer trusts, and MEWAs. Another administrative rule (§§ 20:06:13 43 to 20:06:13:43.02) has been promulgated for Medicare supplement insurance, but is applicable to all health sales to seniors, that tracks the Minnesota statute in judging suitability on the basis of the prospective insured’s financial condition, need for insurance, and existing insurance in comparison to the recommended insurance.

5. Vermont

Vermont has a statute (tit. 8 § 4724) that defines as an unfair or deceptive practice “soliciting, selling or issuing an insurance policy when the person soliciting, selling, or issuing the policy has reason to know or should have reason to know that it is unsuitable for the person purchasing it.” The statute appears to apply to all insurance products, and does not provide any guidance on how to judge suitability.

The inclusion of a suitability standard in Vermont’s Insurance Trade Practices Act is considered an important and useful regulatory tool by Vermont regulators. The Vermont Department has applied this standard in a variety of areas including market conduct and consumer services. It has not been a controversial standard to apply, according to the Department.

The Vermont Consumer Service Section has received 68 complaints that related to misrepresentation by an agent in the sale of life insurance products since January 1, 1997. These types of complaints are generally difficult to resolve because of factual disputes regarding statements that may have been made at the point of sale. Nonetheless, the section will analyze the transaction to determine the needs of the applicant and whether the producer provided a policy that met those needs. In some cases, the insurer has reversed transactions as a result of determining that the producer did not provide the type of policy that the applicant needed or wanted. The basis for evaluating the sale in these instances was the suitability provision in the Insurance Trade Practices Act.

Examples include:

- Complainants were sold a whole life policy that provided no short-term liquidity except through loans or surrender. The complainants were in their sixties at the time that the policy was sold. Their stated purpose for purchasing the policy was to provide an income stream upon retirement. The whole life product did not meet these needs and the Department was able to reverse the transaction.
A 68-year-old farmer was sold an annuity that would not begin to pay out until he was 88. His money would be tied up with him being allowed to withdraw only a small portion of his funds until he reached the age of 88. He was looking for a policy that would provide retirement income. This policy did not meet that need and the Department was able to reverse the transaction.

In both of the above examples, the Department was able to negotiate a resolution with the company as a result of imposing the suitability provision of the Insurance Trade Practices Act. In both instances the company agreed to rescind the contracts and refund all premiums paid with interest to the policyholders. The policyholders were then able to purchase the type of policy that met their needs. Without utilizing this provision, the insureds would have been required either to keep policies that was not in their best interest, to surrender the policies and suffer severe financial penalties, or to go through the expense of beginning legal procedures against the agents and companies regarding misrepresentation on the part of the agents. After exploring these complaints with the companies involved, they agreed with the Department’s analysis that the policies were not suitable.

6. Wisconsin

Wisconsin has an administrative rule (Ins. 2.16(6)) providing that no insurer or intermediary may recommend to a prospective buyer the purchase of a product “without reasonable grounds to believe that the recommendation is not unsuitable to the applicant.” The rule applies to “the purchase or replacement of any individual life insurance policy or annuity contract.” Individual policies issued on a group basis are excluded. The regulation provides the following guidance on judging suitability: “the insurer or intermediary shall make all necessary inquiries under the circumstances to determine that the purchase of the insurance is not unsuitable for the prospective buyer.”

Wisconsin has found its suitability rule to be particularly helpful in resolving consumer complaints. The rule provides helpful leverage when the Department is working with agents and companies to resolve cases where a sale arguably didn’t take proper account of the consumer’s circumstances. The Department has not exercised its sanctioning authority against single acts of unsuitable sales, but has penalized agents for the general business practice of engaging in unsuitable sales. The Department has found its suitability standard to be more readily applicable to Medicare supplement and long term care policies than life and annuity products.

B. Other States with Some Suitability Standards

1. New Mexico

New Mexico has an administrative rule (tit. 13 § 10.8.50) that requires an agent to “make reasonable efforts to determine the appropriateness of a recommended purchase or replacement” of a Medicare supplement policy or certificate.

2. Ohio

A 1992 Ohio bulletin (92-1) relies on an unfair trade practices statute (§ 3901.20) to require agents to “determine the status and suitability of any and all products he or she markets.”
3. Utah

Utah has a statute (§31A-23-303) that authorizes the commissioner to find certain products “inherently unsuitable.” This power has not been exercised.

VI. COMPARISON OF THE INSURANCE AND SECURITIES INDUSTRIES

In analyzing whether suitability standards should be applied to the marketing of non-registered insurance products, it has been suggested that there are significant differences between the marketing of such products and the sale of securities. One important difference is that with securities (which include registered insurance products) the investor’s principle is at risk while with non-registered insurance products it is not. There are, however, other aspects of the marketing of these two financial products that should also be examined before reaching any conclusions as to the appropriateness of suitability standards. Below is an analysis of the various parties and elements involved in sales of registered securities and non-registered insurance products including the products, the issuers, the sales representatives, and finally the customer.

A. The Products

Securities include stocks, bonds, variable life insurance, variable annuities and mutual funds. Non-registered life insurance and annuity products include traditional whole life and term life insurance, some of which pay dividends; interest sensitive life insurance; fixed dollar annuities, both immediate and deferred, single and flexible premium life insurance and annuities; and equity indexed life insurance and annuity contracts.

As indicated previously, the most significant difference between registered and non-registered financial products is principal risk. With registered products, an investor could experience a loss of principal. This is generally not true of non-registered products, although there are instances where such “losses” could occur. For example, the early surrender of a life insurance, particularly in the first two years, would result in the loss of all or most of the premiums paid. Similarly, the surrender of an annuity contract, which often has seven years of surrender charges or a front-end load, can result in the loss of a portion of the contributions made.

Even though certain registered products include an element of life insurance protection, securities were historically clearly distinguishable from non-registered life insurance policies. Beginning in the late 1970s, the life insurance industry introduced a new generation of life insurance products commonly termed “interest sensitive” or “universal life insurance.” This new generation of products has blurred the differences between product types that once were clear. The investment component in these policies promised the potential of far greater returns in the form of excess interest credits. The products were designed to appeal to a marketplace that had begun to eschew the traditional life insurance products, which offered modest equity development, in favor of individual retirement accounts, money market accounts and mutual funds. The promise of excess interest credits as an avenue to share in the high interest returns insurers were experiencing, coupled with the annual resetting of the mortality costs, served to highlight the investment features and minimize the costs of insurance protection. When interest rates declined and the stock market flourished, equity-indexed products were introduced. These products offer an opportunity to participate in the insurer’s returns on equity investments, again appealing to a marketplace that frequently is turning to registered products rather than traditional life insurance to fund its future financial security. Equity-indexed products provide purchasers with the
opportunity to participate in at least a portion of the insurer’s equity investment returns by linking the growth of contributions to a particular stock market index.

B. **The Issuers**

Securities were traditionally not sold by life insurance companies. Insurers offered life insurance, not investments. Insurers traditionally offered life insurance products that protected consumers against financial loss due to premature death. Insurers began to sell policies with cash values available upon surrender and nonforfeiture options, which were triggered if the policies lapsed with cash value.

Today many life insurers also offer mutual funds and variable life insurance policies and annuity contracts through agents who are NASD registered broker-dealers, in addition to the traditional life insurance and fixed dollar annuity products. Similarly, banks and other financial institutions have begun to sell insurance products including non-registered life insurance and annuity contracts. Individuals who visit a local bank with the intention of purchasing a Certificate of Deposit or opening an Individual Retirement Account can find themselves referred to the insurance desk and offered a fixed-dollar or equity-indexed annuity. It is also true that someone who contacts a broker to purchase a mutual fund, stock or other security might be offered the same non-registered products.

C. **The Sales Representatives**

Like the products sold in years past, investment brokers and advisers were distinct from life insurance agents. Investment brokers did not sell life insurance and life insurance agents did not advise or broker stocks or other securities. Today it is common for investment brokers to be licensed to sell life insurance and annuities.

Life insurance, once sold “door to door,” is now made available at the same locations as other investment vehicles are available, including investment houses, banks and on the Internet. And, as indicated previously, life insurance agents now bring registered products in the forms of mutual funds, variable life insurance and variable annuity contracts to the same kitchen tables where previously only traditional life insurance and fixed dollar annuities were sold.

While applicable licensing and appointment requirements provide a minimum standard of knowledge, the levels of professional experience and expertise maintained by individual sales representatives will vary. Today’s financial services sales representatives face considerable continuing education challenges in order to remain current and up-to-date concerning the wide array of financial products, both insurance and non-insurance, registered and non-registered. Despite these safeguards and continuing education efforts, it is uncertain whether these multi-disciplined sales representatives can bring the same depth of expertise to the table that was once available from the sales representatives that specialized in life insurance or securities. Common to both the registered broker and the licensed insurance agent is the method of compensation. Both are compensated through commissions, amounts that are contingent upon the sale of a product, usually a percentage of the cost and not dependent upon the performance of what was recommended.

D. **The Customer**

Although life insurance was sold to people of every walk of life, rich and not so rich, educated and uneducated, sophisticated and unsophisticated, securities were once purchased primarily by the wealthy, educated and sophisticated. Others did not have the means to invest and did not understand the
complexities of the stock market. For these individuals, who did not have assets to protect themselves and their dependents from financial loss or to leave upon their untimely death, life insurance provided "security." What additional funds they had available after paying weekly or monthly premiums were placed in safe investments that were simple to understand such as bank accounts, Certificates of Deposit or government bonds.

Today, more people have the wherewithal to invest, as evidenced by the popularity of mutual funds. Such vehicles give even the small investor the opportunity to experience the type of returns previously reserved for the large investor. The sellers of life insurance no longer have a captive market and now must compete with the securities industry for investment dollars. To do so, they have developed products that offer potential returns that can be compared with securities. In so doing, the products have become more complex but are marketed to consumers that include the same segment of customers that previously limited their purchases to the traditional, uncomplicated life insurance products. This expansion of the market has created suitability issues that did not exist in the past.

VII. CURRENT CONSUMER PROTECTION TOOLS

A. Standards for Informing and Educating Consumers

*Life Insurance and Annuities Replacement Model Regulation*

In September of 1998 the NAIC adopted the revised Life Insurance and Annuities Replacement Model Regulation. This is a comprehensive regulation that imposes significant new duties upon insurers and their agents. The NAIC developed this new rule in response to concerns over past market conduct abuses in replacement sales. Forty states had adopted one of the earlier versions of this model. Many of these same states likely will revise their current regulation to comport with the 1998 version. So far only Iowa has finished the adoption process.

*NAIC Life Insurance Illustrations Model Regulation*

In 1995 the NAIC Life Disclosure Working Group adopted the Life Insurance Illustrations Model Regulation. The goals of the regulation are to ensure that illustrations do not mislead purchasers of life insurance and to make life illustrations more understandable. Thirty-three states have adopted the model. The Working Group anticipates development of a model illustration regulation for variable life products, with the goal of each model being to provide consumers accurate and comprehensive information prior to and during the insurance sales process.

*Model Advertising Rules*

The NAIC adopted the Rules Governing the Advertising of Life Insurance to address appropriate disclosures in the sale of life insurance. The model rules set forth standards and guidelines to achieve full and truthful disclosure of all material and relevant information in the advertising of life insurance and annuities. The advertising rules also prohibit the use of certain words and phrases that may be considered misleading or deceptive. To inform the consumer of important financial features the model requires that guaranteed and non-guaranteed elements be fully explained and distinguished. Twenty states have adopted this rule, or one of similar design.
Life Insurance Disclosure Model Regulation

The NAIC’s Life Insurance Disclosure Model Regulation requires insurers to provide information to the consumer in order to allow him or her to make an informed purchase of life insurance. The purpose of the model regulation is to require insurers to deliver information in a timely manner to improve the buyer’s ability to select an appropriate plan of insurance for his or her needs. The model regulation also seeks to educate the buyer about the different features of a policy being considered and to improve the buyer’s overall capability to evaluate different insurance policies. To date, 33 states have adopted this model.

Annuity Disclosure Model Regulation

At the 1998 Winter Meeting the NAIC’s Life Insurance and Annuities (A) Committee adopted the Annuity Disclosure Model Regulation. This new model regulation specifies the type of information that must be disclosed as well as the method for doing so. The regulation will assist in informing and educating the consumer about certain basic features of annuity contracts. The project began because of a concern about sales of annuities to senior citizens; however, the model is applicable to most annuity sales. Montana was the first state to adopt this model regulation.

Buyer’s Guides

The NAIC Life Insurance Buyer’s Guide is included as Appendix A to the Life Insurance Disclosure Model Regulation. The Buyer’s Guide provides information to consumers to assist them in making informed decisions when purchasing insurance. The Buyer’s Guide to Fixed Deferred Annuities, with an optional appendix for equity-indexed annuities, is an appendix to the Annuity Disclosure Model Regulation. It explains many of the terms used in sales of annuities and provides questions the prospective purchaser should ask to get more information.

Unfair Trade Practices Act

The NAIC’s Model Unfair Trade Practices Act is designed to prevent deceptive and misleading practices during the sale of insurance. The model act also provides an enforcement mechanism and a framework for regulatory action in this area. This model prohibits deceptive, dishonest or unfair sales practices, as well as unfair methods of competition. To date, 45 states have adopted some form of this model.

NAIC’s Market Conduct Examiners’ Handbook

During 1995 and 1996 the Handbook underwent major revisions. During the course of this review numerous new models were incorporated into the Handbook to serve as a guide for states when developing their own state-specific handbook.

Long Term Care Insurance Model Act

This model act specifies disclosure standards, renewability and eligibility terms and conditions, and other performance requirements for this specific line of business. This model also requires the delivery of an outline of coverage during the initial solicitation and again with the delivery of the policy. Forty-six states have adopted some or all of the model act.
VIII. VOLUNTARY SUITABILITY STANDARDS

A. Insurance Marketplace Standards Association (IMSA)

Over the past several years, negative publicity in the popular and financial press has thrown the industry’s market conduct into the public spotlight. The cumulative effect of adverse publicity could inflict long term damage to the life insurance market. Indeed, the deteriorating public perception of the industry’s image has been vividly quantified in trend data generated through ACLI attitudinal research. Left unchecked, the views elicited by the public surveys translate into direct economic consequences affecting everyone in the life insurance business.


During the late 1980s and early 1990s incidents of industry sales abuses and questionable business practices frequently became front-page news. More important than the potential loss of revenue that could result from these practices was the issue of the loss of consumer trust. Of equal concern was what to do about it. Both the insurance industry and the state regulators had to address this issue and find a way to correct it.

In response to the negative publicity received by the life insurance industry, and based upon the collective experience of several states, these states recommended that the issue of company compliance be pursued at the national level. After a multi-state examination in 1995, several states came to the conclusion that they needed to examine industry compliance programs. The five states involved formed a group within the Midwest Zone to examine industry compliance programs and the means by which regulators may encourage the industry in self-monitoring. One of the goals of the group was the establishment of a process for regulators to work with the industry to develop industry standards for self-monitoring for the adherence to regulatory standards and good business practices.

The five states decided to develop a model reciprocal compliance program to capitalize on the industry desire to project a public image of honesty and trustworthiness by establishing a process for regulators to work with the industry to develop industry standards for self-monitoring and discipline. The regulators hoped to strengthen and broaden insurance industry adherence to regulatory standards and good business practices in all states by encouraging insurers to establish or strengthen compliance programs.

During the NAIC Spring National Meeting in March 1996, members of the Midwest Zone invited the insurance industry to make presentations about their current practices regarding compliance, as well as to present company proposals to address the many concerns of the public, the regulators and the industry. Many company representatives attended this meeting and made comments ranging from “no state involvement is needed,” to “no type of corporate compliance program is necessary” to “such a program would be too expensive.” Given the broad plan that the group started with, and the apparent lack of consensus at the time for drafting such a comprehensive program, it was decided that the states would not pursue drafting a mandated program but would, instead, continue to monitor these issues through the various NAIC groups. To date, committees such as the Replacement Issues Working Group, the Suitability Working Group, the Life Disclosure Working Group, the Market Conduct and Consumers Affairs Subcommittee, and various *Market Conduct Examiners Handbook* working groups, have continued to discuss these issues.
Also during this time period, The ACLI Task Force on Market Conduct, comprised of 16 life insurance company CEOs, drafted its own recommendations. From this task force came the "Code of Life Insurance Ethical Market Conduct" which contained six principles and a code of conduct for each principle. These principles became the foundation of the Insurance Marketplace Standards Association.

The Insurance Marketplace Standards Association (IMSA) is a voluntary membership organization whose purpose is to promote high ethical standards in the sale of individual life insurance and individual annuity products by its member companies. Through its Principles and Code of Ethical Market Conduct, IMSA encourages its member companies to develop and implement policies and procedures to promote sound market conduct practices. Companies must undergo a rigorous self and independent assessment of their practices to become a member of IMSA. IMSA membership must be renewed every three years to reasonably assure continued compliance with IMSA's Principles and Code. By promoting collective performance improvement, the Program aims to strengthen consumer confidence in the life insurance industry.


The principles are as follows:

1. To conduct business according to high standards of honesty and fairness and to render that service to its customers which, in the same circumstances, it would apply to or demand for itself.

2. To provide competent and customer-focused sales and service.

3. To engage in active and fair competition.

4. To provide advertising and sales materials that are clear as to purpose and honest and fair as to content.

5. To provide for fair and expeditious handling of customer complaints and disputes.

6. To maintain a system of supervision and review that is reasonably designed to achieve compliance with these Principles of Ethical Market Conduct.


The intent behind the six principles is that a company can use the principles as a guide to review its own compliance with each principle prior to undergoing a review by an independent third party assessment of that compliance. Upon demonstrating compliance with these principles, a company then becomes a member of the IMSA. Membership in the association serves to recognize the companies that have successfully completed the assessment program. A company is allowed to publicize its membership in the association through its advertising and sales materials. Currently the IMSA standards address only the advertising and sales practices for individual life and annuity products and long-term care insurance.
IMSA requires its member companies to comply with IMSA’s “needs-based selling” standard embodied within IMSA Principle 1. IMSA member companies are required to reasonably assure that the insurable needs or financial objectives of their customers are determined based upon relevant information obtained from the customer and that customers receive information consistent with making buying decisions about what is appropriate for them. To meet this standard, companies must encourage the use of fact-finding tools in their marketing and sales activity. By complying with these requirements, IMSA member companies conduct activities to enter into transactions designed to assist the customer in meeting his or her insurable needs or financial objectives.

B. Other Voluntary Suitability Measures

Aside from the IMSA standards, the working group received testimony that indicates that many insurers and producers engage in activities intended to identify the financial needs of a customer, to assess the appropriate product to fit those needs and to match the most appropriate products to those needs; in short, to insure the suitability of a proposed sale. Particularly in those companies, agencies or brokerages where registered products are sold, many companies and firms have voluntarily extended the procedures required by the SEC and NASD rules to non-registered products. The vehicles used to accomplish this are often referred to as needs analyses or assessments. Whatever the vehicle, the intent is the same, to obtain sufficient information from the prospective client to know what products would be best for the person’s financial circumstances.

The working group gained insight into such a voluntary program as a result of a presentation given at the 1998 NAIC Winter National Meeting by representatives of Edward Jones. Edward Jones is a full service brokerage firm that sells both registered and non-registered products, including fixed annuities, life insurance and long term care insurance. The foundation of the program is the New York Stock Exchange (NYSE) Rule 405, which demands that the broker “Use diligence to learn the essential facts relative to every customer...,” commonly known as “Know Your Customer.” Edward Jones accomplishes this through a new account form that collects information about the customer including age, net worth, annual income, investment objectives and investment experience. The broker enters the information into the firm’s computer system. All annuity and life insurance applications, registered or not, must be sent for suitability review by the home office. The system verifies certain suitability rules; any transactions that exceed the suitability business rules receive heightened review by a supervisor.

Annuity sales are assessed for suitability through the application of four factors: investment objectives, diversification, age and time horizon. Life insurance sales are also assessed against four factors; amount of coverage, ability to make premium payments, time horizon and risk tolerance. The suitability of annuity and life insurance exchanges is given even greater scrutiny. All are reviewed by a supervisor taking into consideration surrender charges, liquidity needs, changes in objectives or needs, financial benefits to the client and client awareness of new expenses and contract or policy limitations. The supervisor is vigilant in identifying reasons why exchanges may not be suitable such as a poor relationship with the original agent, convenience or the good performance of the existing product.

While the above is descriptive of only one firm’s suitability efforts, the working group has been made aware that other companies apply similar measures on a voluntary basis.

IX. INDUSTRY VIEWPOINT

The working group invited the insurance industry to submit its viewpoint on this topic. Comments were received from two industry trade associations, and they are attached as Appendices A and B.
X. THE FINANCIAL SERVICES MODERNIZATION ACT

In 1999, after much discussion and negotiation, the Financial Services Modernization Act (Gramm-Leach-Bliley Act) was signed into law by President Clinton. Among its many provisions is a section entitled the National Association of Registered Agents and Brokers, or NARAB. The NARAB provisions provide for a national registration system for insurance agents and brokers, which will be established unless, within three years of the Act's effective date, 29 states either agree on reciprocity of licensing or have uniform licensing standards. Among the uniform standards required by NARAB is a standard that requires uniform suitability requirements for the sale of insurance products in all lines. The NARAB provision regarding suitability reads, in its entirety, as follows: “Establish uniform criteria to ensure that an insurance product, including any annuity contract, sold to a consumer is suitable and appropriate for the consumer based on financial information disclosed by the consumer.”

The states have initially determined to seek to satisfy NARAB’s requirements through the reciprocity route. However, it is clear that many states believe that uniformity is ultimately the preferred choice. If uniformity is to be achieved, suitability standards for the sale of non-registered annuity and insurance products will need to be developed.

XI. CONCLUSIONS AND RECOMMENDATIONS

A. Conclusions

The requirement that the sale of an insurance product be suitable for the customer to whom it is sold has existed, to some degree, for some time. The NASD has required suitability in the sale of registered insurance products for more than forty years. Its rules, as well as the rules of the New York Stock Exchange, correctly recognize that in order to be in a position to make a suitable sale, the seller must know its customer. The rules, therefore, are geared toward first obtaining information about the customer’s financial situation and objectives and then taking all available information into consideration in determining the product that is suitable for that customer.

The NASD has successfully applied its suitability rules in both field examinations and investigations of specific customer complaints. Investigation of specific complaints has led to disciplinary actions against registered representatives. Where the actions have been contested, the NASD actions have been successfully upheld. The success of these disciplinary actions has served to promote compliance within the industry with the suitability requirements. The NASD has issued bulletins as it has found it necessary to explain and give guidance to the regulated community of its interpretation of their responsibilities under the suitability rules. These bulletins have covered a panoply of issues from supervisory responsibilities to suitability with respect to specific products such as annuities or specific market segments such as seniors.

As to non-registered products, as many as one-fifth of the states already have rules requiring that sales be suitable, or not unsuitable. Feedback from five of those states indicates that the existence of rules has been helpful in resolving individual complaints. Suitability requirements have proven particularly helpful where violations of other rules cannot be documented. In some sales, the producer may have complied with all other requirements, accurately representing the terms and conditions of the product sold and giving all required disclosure, but still has not made a suitable sale. Whether or not the
producer is successfully subjected to disciplinary action, the producer’s failure to make a suitable sale has enabled regulators with a suitability standard to get the transaction reversed.

Some may argue that a few isolated instances where suitability rules were needed to protect a purchaser from an improper sale do not provide support for comprehensive suitability requirements in the sale of non-registered products. The absence of principal risk and the plethora of presale disclosure requirements and policyholder protections argue against imposing such standards. The development of suitability standards at this time for non-registered products is premature, they maintain, until there is more experience to demonstrate that recently developed or amended rules fail to address the sales practice concerns that give rise to the suggestion that suitability rules are needed. Opponents point to the history of successful regulation prior to the recent sales practice allegations as evidence that such rules are not needed and would be an overreaction.

In response, the working group concludes that the development of suitability standards in the sale of registered products may be long overdue. Principal risk is not the beginning and end of the suitability questions. If the product sold does not meet the needs of the customer, the cost of that product was incurred unnecessarily and therefore is lost. Accordingly, whether the product is appropriate for the particular customer is the real crux of the issue, regardless of principal risk. Appropriateness of a sale is not the exclusive domain of registered products; it is equally important in the sale of non-registered products.

Further, it is not the sales practice concerns that lead to the conclusion that the time for suitability requirements has arrived, but the factors that contributed to them. Over the last two plus decades, non-registered products have become increasingly complex. The investment components and the emphasis placed upon these components in sales have become more prominent. Complex hybrid products are offered to customers in all walks of life and of all financial means, often as alternatives to registered products and investment vehicles. More frequently, the people marketing the non-registered insurance products are also offering registered insurance products. Disclosure requirements are no longer sufficient consumer protection in such an environment. Besides, there would appear to be no valid reason to relieve a sales representative of the burden of insuring the product is appropriate and thus the sale suitable, depending upon what product the representative pulls from his or her portfolio of available products. In each case, the customer relies upon the representative’s recommendations as to what product is best for that customer, yet the sales representative’s commission based compensation is not dependent on how well the product performs or actually meets the customer’s needs.

While the working group applauds the initiatives embodied in the IMSA standards and the other voluntary measures many companies and firms have taken, the working group does not feel that these initiatives are an adequate or sufficient substitute for suitability rules. The IMSA program, certainly a step in the right direction, is voluntary and not enforceable by regulators. Likewise, other voluntary measures cannot substitute for requirements. The establishment of suitability rules will ensure that these factors will be considered in every sale by every company or firm. Existing voluntary programs are instructional, however, in designing suitability rules and should be looked to in developing the rules. Finally, if states are to achieve the uniformity required by the NARAB provisions of the Financial Services Modernization Act, suitability standards will have to be developed for all lines of insurance.

B. Recommendations

The working group recommends that rules be developed requiring that suitability be determined by the producer and carrier in the sale of non-registered life insurance and annuity products. In doing so, it
would be appropriate to develop both a model act, which gives clear authority to states to promulgate suitability rules and a model regulation that would specify the standards and requirements that must be met. Ample information and procedures exist to assist in developing the rules. To the extent possible, voluntary programs and procedures should be incorporated into the rules so as to minimize the costs to the regulated community in implementing the required rules. The developed rules should identify and make special provisions, where appropriate, for specific products or market segments.
Appendix A

AMERICAN COUNCIL OF LIFE INSURERS COMMENTS ON WHITE PAPER ON SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES

The ACLI believes that there are distinct characteristics of fixed life insurance and annuity products and of their regulation which make the development and implementation of standards for determining the suitability of individual product sales problematic, if not impossible. We are concerned that, if such standards are to be developed, making them appropriate for our industry's variety of products, distribution channels and customers will require an investment of time and resources which may be disproportionate to the ultimate usefulness of the end product. We would urge that consideration be given to alternative options using the regulatory tools already in place.

Securities regulation is based on a free market for products. Those products differ in many ways from life insurance and annuities, whether fixed or variable, as do insurers from the offerors of securities. For example, in contrast to the offeror of a security which assumes no risk as a result of a purchase by a customer, an insurance contract directly involves the assumption of the customer's risk by the insurer. Insurance regulators, therefore, are properly concerned with the soundness of the insurance company and the operation of its products. Guidelines already exist, however, for appropriate oversight in both those areas. In addition, an insurer is required to use only marketing materials which accurately describe both the product and the insurer and to be neither deceptive nor misleading. We believe that these are the sorts of standards which are most effective in regulating the business of insurance.

It is true that what have come to be called suitability standards exist in the securities industry. The NASD and the SEC adopted their standards applicable to the sale of securities to require that broker-dealers and their registered representatives have both a reasonable basis for recommending the purchase of a security and cause to believe that such a recommendation was not unsuitable to the needs and circumstances of the customer, based on information disclosed by the customer. The regulatory concern underlying these standards was the desire that a recommendation to purchase securities would be made after reasonable inquiry into the ability of the purchaser to tolerate potential financial loss. This concern, as noted in the white paper, is not applicable in the insurance market. Insurance premiums are not lost, as investment dollars may be, but rather are used to fund insurance coverage which provides a continuing, real benefit.

In looking at life insurance and annuity products, it is essential to recognize the long-term nature of the needs for which an insurance product is purchased and the potential for change in the circumstances of the owner, insured and beneficiary during the time the product is in force. The combination of a long product life and the fast changing environment in which customers live make the retrospective view of what constituted a "suitable" sale very difficult to apply objectively to a transaction entered into based on a prospective view. This is one of the reasons that the regulation of fixed life insurance and annuity products is based on substantive review of the products and strong regulation of advertising materials, with an absolute prohibition against misleading and deceptive sales practices.

We believe that the distinctions between the securities industry and the life insurance industry, both in terms of products and customer relationships, are so significant as to strongly suggest that the imposition of suitability standards, similar to those applied to the sale of securities, to the sale of fixed life insurance and annuity products is not appropriate. The evaluation of an individual's risk tolerance is not readily applicable to a product where there is not the potential for principal fluctuation that exists in securities.

© 2000 National Association of Insurance Commissioners 25
ACLI has long recognized and supported efforts to ensure that consumers have adequate information about life insurance and annuity products so that they can make knowledgeable purchasing decisions. We would note that the NAIC has developed a number of model laws and regulations which are described elsewhere in the white paper and which are aimed at achieving this goal. It is our recommendation that affirmative disclosure requirements and strong enforcement of rules prohibiting misleading or deceptive advertising should continue to be the focus of regulators concerned about sales practices. Thus, if it is the conclusion of this white paper that additional regulation is necessary, we would urge the NAIC to concentrate its efforts in these areas.

The requirements embodied in the NAIC Model Unfair Trade Practices Act (UTPA), which has been adopted in some form in virtually every state, are examples of the sort of regulation which the industry has long operated under and which we believe has been effective. The UTPA provides clear authority for regulators to deal with sales which are based on misrepresenting a product. Embodied within the UTPA and other disclosure requirements applicable to a number of fixed life and annuity products is the concept that an informed customer is the best judge of what meets his or her needs at the time of purchase. Appropriate regulatory oversight of products, advertising materials and agent education work together to assure the availability of information necessary to all parties involved in making a knowledgeable purchase. In addition, life insurance and annuity products contain “free-look” provisions which permit customers to reflect on a purchase and, if they decide the product does not meet their needs, return the product and receive their money back.

At point of sale, a number of options are available for making the sales process better, including sales illustration regulation and the requirement that product buyers guides be provided. We believe that making information available to the customer by which he or she can determine whether the product suits either or both present circumstances and known future needs is appropriate and effective regulation. In particular, we believe that disclosure is the tool best designed to deal with the regulatory concern set forth in the white paper about the complexity of current insurance products. The level of complexity of a life insurance policy or annuity contract is not determinative of its suitability for a particular purchaser. It may, however, affect the ability of the purchaser to use the product’s features appropriately to respond to changes in circumstances or meet unanticipated needs. Thus, continued emphasis on consumer education and product disclosure is where attention should be placed.

Current law protects the insurance consumer in a variety of ways. Underlying much insurance market conduct regulation is the concept that an informed purchaser is the best judge of what may be “suitable” (or “not unsuitable”). Unlike securities regulation, where suitability standards act as a protection against undue risk taking, insurance regulation focuses on the marketing of products, reviewed by the regulator, by financially sound companies, examined by the regulator. Comprehensive laws and regulations govern the flow of marketing and advertising information from agents and companies to consumers. These requirements also mandate cost information, prohibit misrepresentation, forbid misleading or deceptive statements, proscribe incomplete comparisons, and outlaw improper, inducements, tie-in sales, and unfair discrimination.

It is also important to recognize here that suitability standards in the securities industry are only one part of a regulatory scheme designed to encompass a marketplace which is significantly different from that in which insurance products are sold. First, the individual who sells securities generally has no direct relationship with the offeror but rather places his registration with and is compensated through a broker-dealer which is the contractual agent of the customer. As part of this arrangement disputes between the broker and the customer are usually resolved through binding arbitration, using rules and procedures
established by the NASD. In contrast, in the insurance marketplace relationships between sales representatives and insurers vary. The sales representative may have a direct relationship with the insurer either as a career/captive agent who sells only its products or as an independent broker who selects some or all of the products of a number of insurers as part of a portfolio. Insurance agents and brokers are tested and licensed by the states, frequently subject to mandated continuing education requirements and governed by a variety of laws and regulations dealing with most aspects of their conduct. Complaints about the agent may be brought to the insurance company and, if necessary, the state insurance department but resolutions arrived at there are not legally binding on the complainant. Consequently, time-consuming and costly litigation may still arise from such complaints despite an insurer's best efforts to resolve them through the insurance department. Introducing new responsibilities and new causes of action with few or no standards of compliance established and lacking any regulator-sanctioned recourse to any other method of binding dispute resolution is not a prospect which insurers can approach with anything other than trepidation.

In examining all the laws and regulations already in place in the states or available as NAIC models, we conclude and urge the recognition by the Working Group that regulators have the necessary tools available to them to ensure that insurance products are properly sold to consumers who have access to relevant information and access to regulator oversight. The difficulties inherent in developing standards for determining the suitability of sales of fixed life insurance and annuities are formidable when considering the variety of needs which these products may be selected to meet. We once again would urge a full and careful consideration of the existing legal and regulatory tools available and ways to improve their content or utilization before embarking on the development of new and, we believe, unneeded suitability standards.
Appendix B

NATIONAL ALLIANCE OF LIFE COMPANIES COMMENTS ON WHITE PAPER ON SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES

The white paper does not recognize that there are many basic differences in relationships between securities sales and insurance product sales.

Agency Differences
Most fundamentally, the securities broker is an agent of the buyer, whereas the insurance producer is an agent of the seller. Under long established principles of agency law, an agent is a fiduciary of his or her principal, and owes the principal duties of good faith, loyalty and honesty, among others. The NASD's suitability rule basically is a corollary of agency duties already owed by the securities broker to the customer, as is the general rule that the securities broker is a fiduciary of the customer. The securities broker normally has no relationship with the supplier of the security.

In contrast, the insurance producer has a contractual relationship with the product supplier and is its agent. The white paper's recommendation that the company and its agent-producer assume a duty to act on behalf of a third party to their relationship would muddle the clear principal-agent rules and standards which have always existed in fixed product insurance transactions, and replace them with uncertainty which would ultimately be resolved, at great expense and in a patchwork fashion, by innumerable lawsuits.

Securities Brokers Sell Securities
When the customer places an order all that is to be done is to purchase securities through an exchange or over-the-counter on the terms dictated by the customer. The securities broker is the customer's agent throughout the transaction. In the same sense, an insurance producer does not sell life insurance and annuities (he or she rarely has binding authority). Rather, the life insurance producer generates interest in life insurance products, and conveys offers to purchase policies to his or her principal, the insurance company, which thoroughly evaluates the offer, and may fill it, reject it or convey a counteroffer. An insurance purchase is much more of an arm's length transaction than purchase of a non-insurance security. In pursuit of their own interests, an insurance producer and insurance company would not knowingly place a product if the applicant could not then afford the premiums. The policy would lapse, at substantial cost to the insurer, which has spent a great deal of money to underwrite and issue the product and often to the producer as well, whose commission may be recovered in whole or part. In addition, a producer who does not provide good policy persistency to the insurance company will be a drain on company resources and subject to termination. Thus, there are protective checks and balances in the typical sale of an insurance product, which do not exist in securities sales.

Free-Look Provisions
A person who purchases a life insurance or annuity policy has a period of time after delivery of at least ten days, and often as much a thirty days, within which to rethink the purchase. During this period the policy may be voided by the purchaser for any reason (including that the product is not suitable) or no reason. If the consumer choose not to keep the policy within the free-look period, all premiums paid will be refunded. There is no analogous free-look period in sales of non-insurance securities products. The free look requirement is premised on the understanding that the purchaser, not the insurance producer or insurance company, can best determine for himself or herself which if any products best fit the particular circumstances. An applicant is permitted to repent a hasty or poorly considered decision at no cost. It appears that the new suitability requirements would transfer the responsibility for product suitability
from the purchaser to the producer and insurer. This change would make protections such as the free look requirement obsolete.

Insurance Department Policy Review and Approval
An additional and unique protection is afforded the purchaser of an insurance product by the fact that insurance regulators make substantive reviews of products which are submitted to them for approval. Often there are statutory standards for approval in addition to a grant of regulatory discretion. In contrast, securities regulators only review registration filings for proper disclosures and make no substantive review of securities products.

The sum of these very basic differences should militate against requiring suitability standards in sales of fixed life insurance and annuity products. In addition, the White Paper’s recommendation of a suitability requirement will open a floodgate of litigation against insurance producers and insurance agents. This is not the case in connection with the sale of securities.

Securities Regulations Provide for Arbitration
Securities regulators have provided a structure for mandatory, binding arbitration of disputes between customers and securities brokers. Arbitration tends to be less expensive and quicker than litigation. However, there is no mandated national standard or provision for arbitration of insurance disputes. The fact that policyholders can sue insurance companies in court for perceived violations of any suitability requirement, but brokerage firms can require that similar disputes be submitted to arbitration is not taken into account in the White Paper’s recommendation. This important difference in the two systems would create an extremely unlevel playing field in favor of securities firms over insurance carriers. As a result, any model act requiring suitability determinations must include a requirement that suitability disputes shall be arbitrated, not litigated.

Many traditional, “vanilla” life insurance and annuity products do not fit within the white paper’s rationale for imposition of securities standards. They are not complex products, and they have not been the subject of national sales practice scandals. Any suitability model act should exclude ordinary whole life and term life products. In addition, a detailed suitability review is not possible for direct response sales, nor for group coverage. Therefore, these products should be excluded.

In summary, we believe that the proper enforcement tools are already in place in the states. Therefore, while we believe that the discussion of suitability is important, we do not believe that a regulation, which would interpose the judgment of a third party into every insurance transaction, is required or is advisable.

Instead, we would recommend a redoubling of the efforts of state insurance regulators to effectively enforce the existing laws and regulations in the states.