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Client Alert

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New York Department of Financial Services Proposes Fiduciary Regulation

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On December 27, 2017, the New York Department of Financial Services (NYDFS) proposed new consumer protections in life insurance sales that would adopt a "best interest" standard for sellers of life insurance and annuity products. In its current form, the Proposal raises a number of issues for producers and life insurers and annuity writers.

If adopted, the Proposal would establish a New York-specific standard for insurance licensee conduct by expanding the scope and requirements of New York's suitability regulation, which currently applies to annuity contracts. This is consistent with New York's approach to the regulation of other issues, such as cybersecurity, where New York has acted apart from its state regulator peers and the NAIC, and essentially forecloses the prospect of a national standard. The Proposal also will overlap in part with the DOL fiduciary rule and a soon-to-be-proposed SEC rule as well as related standards/proposals in states such as Nevada and Connecticut, raising potentially conflicting requirements, compliance challenges, and enforcement uncertainty.

Below are our preliminary thoughts and reactions to the Proposal. Comments on the Proposal are due by February 28, 2018. View the Proposal here.

Scope

- The Proposal would expand the applicability of the existing suitability regulation to include insurance producers, life insurance policies, and in-force policies/contracts. It applies to policies/contracts delivered or issued for delivery in New York.

- The Proposal does not change the existing suitability rule's exemptions except to expand them, along with the overall change in scope, to include life insurance policies used for any of the exempted purposes. Thus, the regulation would continue to exempt policies/contracts used to fund qualified retirement plans, ERISA plans, and employer-sponsored IRAs. The Proposal also would not apply to sales of mutual funds or other securities, unless related to an annuity or life insurance product.

- For all other sales, the Proposal would require licensees to apply a standard very similar to the DOL's "best interests" standard, as well as the ERISA "prudent person" rule. The Proposal provides that a recommendation is in the best interest of a consumer if it is in furtherance of the consumer's needs and objectives and is made "without regard to the financial or other interests of the producer, insurer, or any other party."

- In addition, the Proposal would require insurers to "establish and maintain procedures designed to prevent financial exploitation and abuse" and provide consumers/producers with "all relevant policy information[.]"

DOL Fiduciary Rule: Overlapping Regulation of Certain IRAs

- Because the Proposal excludes ERISA plans, deferred compensation arrangements, and employer-sponsored/maintained IRAs, it avoids a direct clash with the DOL's fiduciary rule. However, there is a fairly substantial amount of overlap between the Proposal and the DOL rule because the Proposal would apply to IRAs not associated with a plan sponsor.

- The NYDFS definition of "recommendation" is similar, but not identical, to the DOL definition. The Proposal provides that a recommendation occurs when the statement(s) "reasonably may be interpreted by a consumer to be advice that results in a consumer entering into or refraining from entering into a transaction." The DOL rule applies to any "suggestion" directed to a person that the person engage in or refrain from a particular course of action. Although the DOL standard is arguably broader than the NYDFS standard, that distinction may not make a difference from a regulatory enforcement or litigation perspective. (For example, the definitions, with their distinctions, will overlap for advice to IRA owners.)

- The Proposal also imposes a different fiduciary standard of care than the DOL rule (and potentially the forthcoming SEC rule) – see below.

Securities Regulation: Standards of Conduct Potentially Inconsistent With Forthcoming SEC Rule

- The SEC updated its regulatory agenda to include plans to propose a uniform fiduciary standard for advisors and broker-dealers within the next year, potentially as early as this spring. Unlike the DOL's fiduciary rule, the proposed SEC rule would apply to all investor accounts, not just to retirement accounts. The SEC Chairman has previously stated that the SEC rulemaking will supplement, rather than replace, the DOL's fiduciary rule.

- The sale of variable annuities and other insurance products that include a securities component presumably would be subject to the rule.

Compliance and Litigation: Practical Challenges

- With the Proposal, forthcoming SEC rulemaking, and the DOL rule, as well as standards in other states, issuers of certain products (and producers) face the prospect of grappling with three potentially different fiduciary/"best interest" standards. Although the outcomes regarding fiduciary status – *i.e.*, what is the fiduciary recommendation and what is the standard of care, may be more or less the same under each standard, licensees would still be facing potentially divergent approaches to enforcement among the regulatory agencies.

- Some of the Proposal's requirements also would impose potentially burdensome compliance obligations. Section 224.4 of the Proposal, in particular, imposes certain requirements that appear impractical. For example, in (l), a producer is considered a fiduciary for recommending a policy, but cannot indicate to the consumer that making such a recommendation is "financial advice" if the producer merely maintains an insurance producer license. In (m), all producers involved in a transaction are subject to all of the requirements of the Proposal, even if they have no direct contact with the consumer (and thus would not have made a recommendation to the consumer), and this provision could be interpreted to apply to a non-resident producer who is not licensed in New York. Further, although the disclosures in Section 224.4(b)(3) are similar to the conditions of the 84-24 exemption needed to avoid prohibited transactions under ERISA, Section 224.4(b)(3) also requires disclosure of, and imposes limitations on, the producer's compensation in accordance with New York's compensation disclosure regulation (Regulation 194) and NYIL Section 2119.

- The Proposal might be construed to create a continuing duty to monitor and provide advice after the sale. In contrast, the DOL rule allows the person making the recommendation to limit or disclaim a duty to monitor.

- The Proposal also could be interpreted to potentially impose a fiduciary obligation on insurers/annuity writers even if the producer did not have actual or apparent authority to act on behalf of the insurer/annuity writer – and when the alleged conduct occurs after the point of sale. This may create more exposure for insurers/annuity writers in litigation relating to a producer's alleged misconduct.

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- With the Proposal, New York further cements itself as a unique playing field for the life insurance industry.

- The Proposal varies from the NAIC's Suitability in Annuity Transactions Model Regulation, which applies a "best interest" standard to annuity sales. The Proposal applies to sales of both insurance and annuity products. The Proposal also defines "best interest" differently from the NAIC Model.

- The Proposal is consistent with New York's individual approach to other sensitive and complex regulatory issues, such as cybersecurity.

- New York apparently continues to view itself as the nation's leading consumer protection agency. In its press release announcing the Proposal, Governor Andrew Cuomo connects and compares the Proposal to the DOL fiduciary rule, stating: "As Washington continues to ignore and roll back efforts to protect Americans, New York will continue to use its role as strong regulator of the financial series and insurance industries to fight for consumers and help ensure a level playing field."

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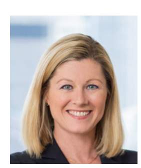

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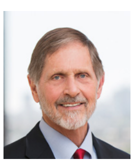

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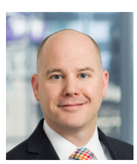

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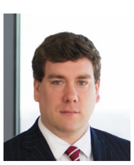

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