# NY Reg 187: Suitability and Best Interest of Clients in Life Insurance and Annuity Transactions

Course 484_NY

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## 1.0 Best Interest of the Client: The Emerging Standard

What is your duty to your client when you make sales recommendations? Must the recommendations be suitable for the client? Yes. Must the recommendation be in the client's best interest? Yes.

But where does this requirement come from. In the state of New York the requirement is based on Regulation 187 "Suitability and Best Interests in Life Insurance and Annuity Transaction."[1]

This regulation became applicable to the sale of annuities on and after August 1, 2019. It became applicable to the sale of life insurance on and after February 1, 2020. This course is designed to acquaint you with the terms of the regulation.

**Learning Objectives**

After completing this course, you will be able to:

- Discuss the fiduciary duties of care and loyalty and how these are related to your determination that a proposed sales transaction is suitable for your client;
- List the situations in which Regulation 187 is applicable to recommendations of life insurance or annuity transactions;
- Describe the types of client information you are required to collect in order to make a proper recommendation;
- Explain what is required for a recommendation to be in the best interest of a client and how the analysis applies to both annuities and life insurance;
- Discuss the special rules that apply to term life insurance and to in-force transaction for which new sales commissions are not paid;
- Explain the special rules that apply to transactions in which an existing policy or contract is replaced by a new policy or contract;
- Describe your obligations to protect senior clients in cases of diminished capacity or financial exploitation; and
- Discuss insurer obligations both to verify that your recommendations are in your clients' best interest and generally to supervise your adherence to the requirements of Rule 187.

## 2.0 Your Responsibility to Your Client

There has been a lot of talk in recent years about your responsibility to your client: should you operate under a suitability standard, or do you have a fiduciary duty to your client, and are you subject to legal liability for violations of that duty?

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[1] [1] This regulation has been upheld by the New York Court of Appeals (highest court in the state). *In the Matter of Independent Insurance Agents and Brokers of New York, Inc. v. New York State Department of Financial Services (October 20, 2022)*. The challenge to the regulation was based on an assertion by the petitioners that terms in the regulation, such as "best interest,""recommendation," and "suitability information" were unconstitutionally vague. The Court of Appeals ruled that, "[b]ecause the Department of Financial Services (DFS) appropriately exercised its authority to create a carefully considered and clear regulation," they found no basis to strike it down. This course is designed to help you understand terms like these.

This course is about New York's Regulation 187, which sets forth your obligations when making recommendations of life insurance or annuities. In the terminology of the regulation, you are required to do two things essential:

- Make sure the recommendation is suitable; and
- Ensure that the recommendation is in the client's best interest and not your own.

These two requirements are—not coincidentally—parallel to the two principal obligations of fiduciaries.

## 2.1 Are you a Fiduciary?

There are many ways you could be a fiduciary. Here is a list of possibilities (there may be more). You could be:

- A registered investment advisor;
- A member of a professional association or hold a designation that requires you to act as a fiduciary;
- A trustee or agent under a power of attorney for your client;
- Giving advice under an agreement with a client that states that you are a fiduciary; or
- Giving advice on a regular basis to a client in the context of a retirement plan covered by ERISA.

The U.S. Securities and Exchange Commission (SEC) has adopted a rule requiring registered representatives to act in the best-interest of their clients[2] and the National Association of Insurance Commissioners (NAIC) has adopted the best-interest standard as an amendment to its annuity suitability model regulation.[3] If you are making recommendations to 401(k) plan participants or IRA owners, the U.S. Department of Labor has adopted a similar standard.[4]

Under New York Regulation 187, you have fiduciary-type duties when you make recommendations to your clients of life insurance or annuity products. This course covers the NY regulation only.

Before we get into the details of the rule, let's consider how fiduciary duties differ from the suitability requirement that has been in operation for some time.

## 2.2 Similarities Between Suitability and Fiduciary Standards

When you are advising clients or handling their money, you have a duty to exercise care. How much care is the subject of this section. If you are working in this business, you should at least be familiar with the suitability standard because it frequently applies and has been around for years. The fiduciary standard is somewhat similar in concept. If you want to understand the fiduciary standard of care, it is useful to compare it to the suitability standard.

Let's start by briefly comparing the two standards:

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[2] "Regulation Best Interest: The Broker-Dealer Standard of Conduct" https://www.sec.gov/rules/final/2019/34-86031.pdf.

[3] "Suitability in Annuity Transactions Model Regulation (MDL-275)." National Association of Insurance Commissioners. https://content.naic.org/sites/default/files/inline-files/MDL-275.pdf.

[4] Prohibited Transaction Exemption (PTE) 2020-02. https://www.federalregister.gov/documents/2020/12/18/2020-27825/prohibited-transaction-exemption-2020-02-improving-investment-advice-for-workers-and-retirees.

- **Suitability.** If you are subject to the suitability requirement, you must have a reasonable basis to believe that your recommendation is suitable for your client, based on information about the client and about the recommendation that you obtained through reasonable diligence.
- **Fiduciary.** If you are subject to the fiduciary requirement, you have the duty to serve the best interests of your client based on information about the client and about the recommendation that you obtained through reasonable diligence (duty of care). You may not put your interest ahead of your client's and you must either eliminate or fully disclose all conflicts of interest, including how you are compensated (duty of loyalty).

Do you understand the difference?

If you do, you may have focused on the **duty of loyalty**. There's nothing in the statement of the suitability rule that technically prevents you from acting in your own interest if your recommendation is *also* suitable for the client. If you get into the details of the law, however, self-dealing is definitely frowned upon even under the suitability rule.

Alternatively, you may have seen a difference in the **duty of care**. The suitability rule says that a recommendation must be "suitable" for the client. The fiduciary rule says that a recommendation must serve the "best interest" of the client. Again, if you dig into the details of the law, you will find the term "suitable" used in connection with fiduciaries and you will find the term "best interest" used in connection with the suitability standard.

Despite the legal fuzziness, you were completely correct to focus on these two duties: the duty of care and the duty of loyalty. The differences between the suitability standard and the fiduciary standard can be seen as differences in degree, though we will see that there is a clear difference in in the duty of loyalty.

Let's first look at the duty of care.

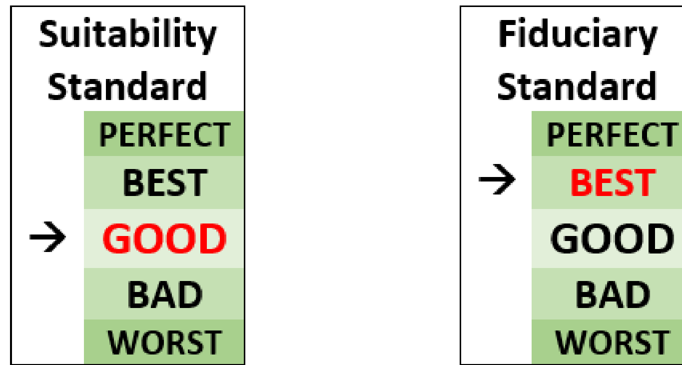
### 2.2.1 Duty of Care

The duty of care is a standard directed to your head. Are you acting on good information—about your client and about the products or strategies you are recommending? Do you know what you are doing? Are you applying your expertise correctly?

These questions apply whether you are subject to the suitability standard or the fiduciary standard. What's the difference between:

- Saying a recommendation is **suitable** for a client, and
- Saying a recommendation is in the **best interest** of the client?

It's a matter of degree. Finding a suitable recommendation for a client may mean finding something that is "good enough" for your client's needs. Finding a best-interest recommendation kicks it up a notch. Finding the best recommendation is not the same as finding a perfect recommendation. You can make the best recommendation in the world, but things don't always turn out as expected. No one expects you to see the future.




Now, let's consider the second aspect of your standard of care, the duty of loyalty.

### 2.2.2 Duty of Loyalty

The duty of loyalty is a standard directed to your heart. Are you on your client's side? Or are there conflicts that might divide your loyalties? This question often focuses on your compensation, but it could be other things.

- Is your recommendation swayed by commissions or other forms of compensation?
- Is it swayed by contests, trips, or other prizes?
- Could your job be in jeopardy if you don't steer your clients to certain products?
- Do you have an ownership interest in a business that could be affected by the recommendations you make?

These are the things that tend to make a best-interest recommendation not even good enough.

Conflicts are a problem even under the suitability standard, but they are a major problem under a fiduciary standard. Historically, there have been two ways to deal with conflicts:

- Eliminate them, and
- Disclose them fully to the client.

We're going to stop here. Different fiduciary rules handle this differently. You will see later in this course that the New York rule wants you not to consider benefit to yourself when making a recommendation, but disclosure is also important.

Before we get into the meat of our topic, we have one last thing to say to you before we get to Reg 187 itself: be sure to document what you do.

### 2.2.3 Documenting Your Recommendations

It is always good practice to keep good records. You need them for yourself. But you also need them to satisfy your supervisors. You need them for your clients. And you need them to satisfy an agency or a judge if your client ever gets upset and reports you.

No one sues you if they are making more money than expected. They sue you if they lose money or if the deal they end up with is worse than they expected. Your clients may be disappointed by their account balances or they may feel that they are doing worse than family or friends who have similar investments.

You cannot be held liable for poor investment performance. You can only be held liable if you breached some sort of duty to your client. If a fiduciary duty is involved, the question is whether recommendations you made were in the best interest of the client. **The judgment should be based on what you knew and did during the time leading up to the recommendation, not what happened afterward.** Neither you nor your firm guarantee results. You only promise your best advice at the time.

But hindsight is 20-20, as they say. And bad outcomes could persuade clients (and their attorneys) that you didn't do what you should have done.

The best way to counter this is to **keep excellent records!** If you have records of all the information your client provided, refusals to provide complete information, statements of needs and wants, records of your analysis, recommendations made to the client (including rejected recommendations), presentations made, etc., your defense could be strong—strong enough even to avert a suit at all.

This has been the high-level view of your obligations to your client. In the next sections we will begin to dig into the specific requirements of New York's Regulation 187.

*Knowledge Check*

Which of the following things could LEAST likely compromise you in fulfilling your duty of loyalty to your client?

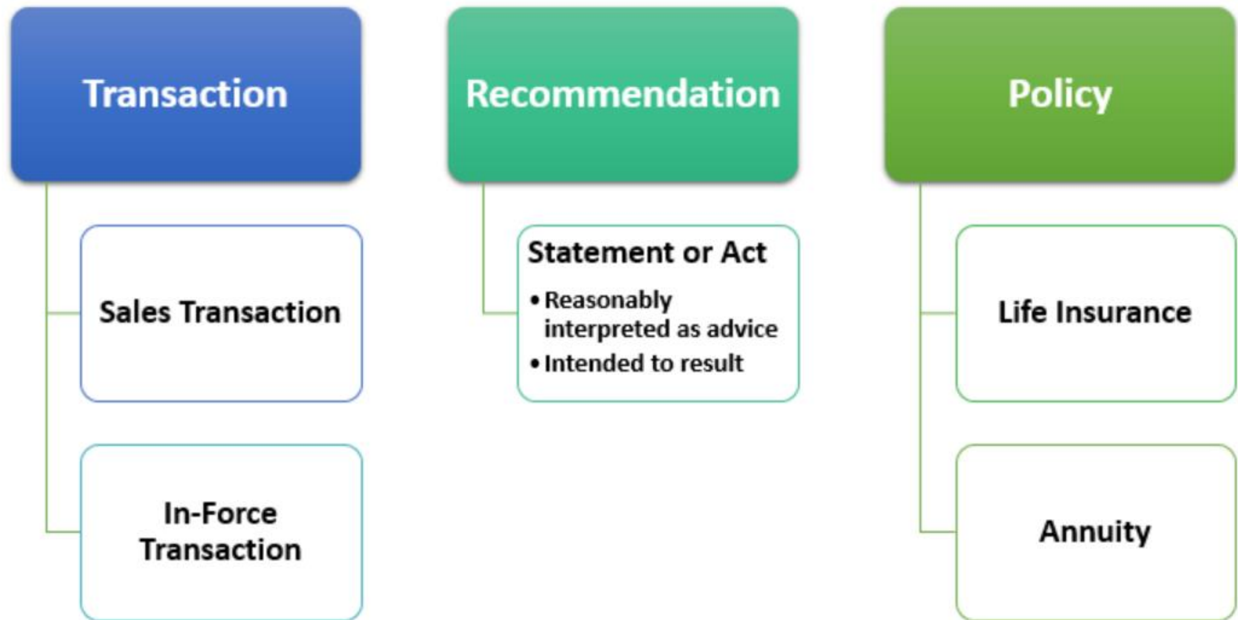
A. You are paid on commission. **[Your answer is incorrect. Commissions create an incentive for you to recommend products offering you the highest commission rather than recommending a product that would be in the best interest of the client. Being a member of a professional association would be unlikely to compromise you.]**
B. You are a member of a professional association that requires you to act as a fiduciary **[Your answer is correct. Being a member of a professional association would be unlikely to compromise you.]**
C. Your job could be in jeopardy if you don't steer your clients to certain products. **[Your answer is incorrect. Job jeopardy creates an incentive for you to recommend products offering you the highest commission rather than recommending a product that would be in the best interest of the client. Being a member of a professional association would be unlikely to compromise you.]**
D. You have an ownership interest in a business that could be affected by a recommendation you make. **[Your answer is incorrect. Your ownership interest creates an incentive for you to recommend products offering you the highest commission rather than recommending a product that would be in the best interest of the client. Being a member of a professional association would be unlikely to compromise you.]**

## 3.0 When Does Regulation 187 Apply

When do you owe these duties to your clients?

If you are selling life insurance and annuities, it could be most of the time. Let's take a look at what New York Regulation 187 says. It's short, so let's look at the regulation text:

> "This Part shall apply to any **transaction** or **recommendation** with respect to a proposed or in-force **policy**." – 11 NYCRR 224.1.



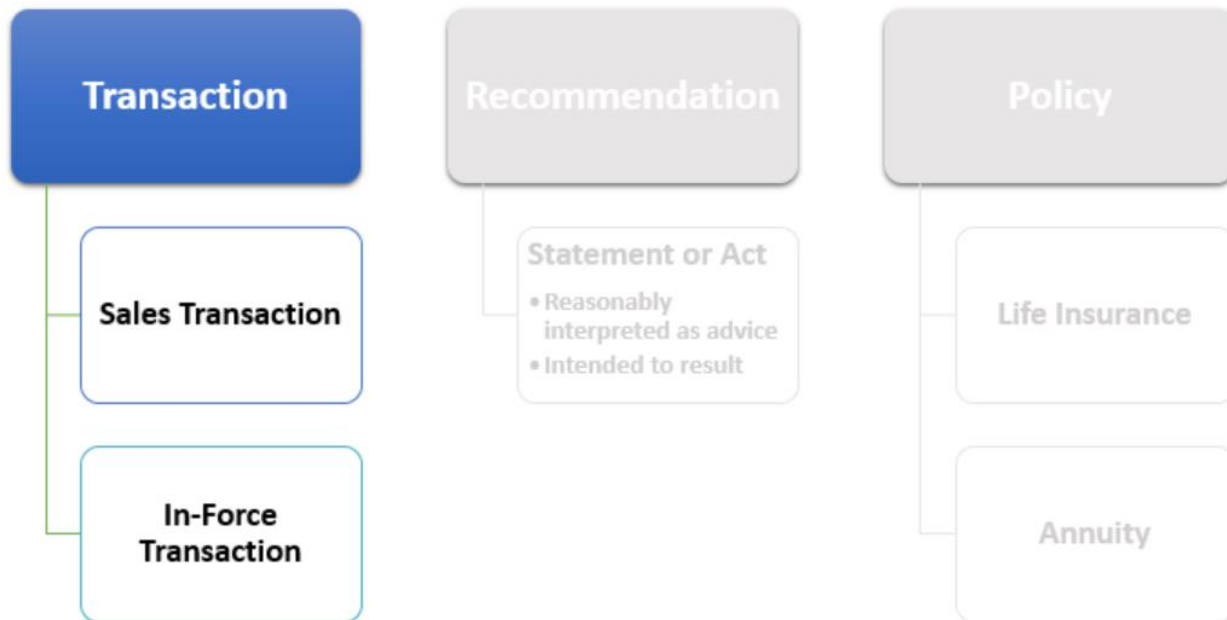

If that seems broad to you, you're catching on. Let's begin by taking this apart. Then we'll move on to the exceptions.

## 3.1 Sales and In-Force Transactions

The regulation first zeros in on "transactions." Two types of transactions[5] are covered by the reg:

- **Sales Transactions.** A sales transaction includes more than just an initial issuance of a policy or contract. It also includes replacement transaction (discussed later in the course), conversions, modification, or elections with respect to an in-force policy that **generates new sales compensation.** Renewal commissions are not considered "new sales compensation." This definition focuses on new sales compensation because you are naturally more motivated to dot all the *i*'s and cross all the *t*'s when your compensation is at stake.
- **In-Force Transactions.** In-force transactions include any modification or election of a contract provision that does not generate new sales compensation. The rules don't let you off the hook in the case of in-force transactions, but the rules are somewhat relaxed in recognition of the fact that you are not getting specifically compensated for the work. In-force transactions are discussed later in the course.

[5] We give a "generic" explanation of sales v. in-force transaction. This distinction may be subject to interpretation, however, so it is important for you to understand how your firm understands these terms.




## 3.2 Defining Recommendation

The next requirement we want to look at is "recommendation." What does that mean?

A recommendation is one or more statements or acts by a producer (or by an insurer, if no producer is involved) to a client that:

- May **reasonably be interpreted as advice** resulting in a client's entering into a transaction or refraining from entering into a transaction in accordance with the advice; or
- **Is intended to result** in a client's entering into a transaction or refraining from entering into a transaction.

The second part of this is probably not going to be a problem. If you make a recommendation and intend your client to follow-through by making a purchase or an investment or by refraining from a particular transaction, you probably wouldn't be surprised to learn that Reg 187 applies to you.

The first part of this is where you could trip up. If you don't mean to make a recommendation, you need to avoid doing things that your clients might reasonably interpret as advice. This is not a subjective test. If your communications to a client add up to something that would reasonably be viewed as advice, the communication will be considered to be a recommendation.

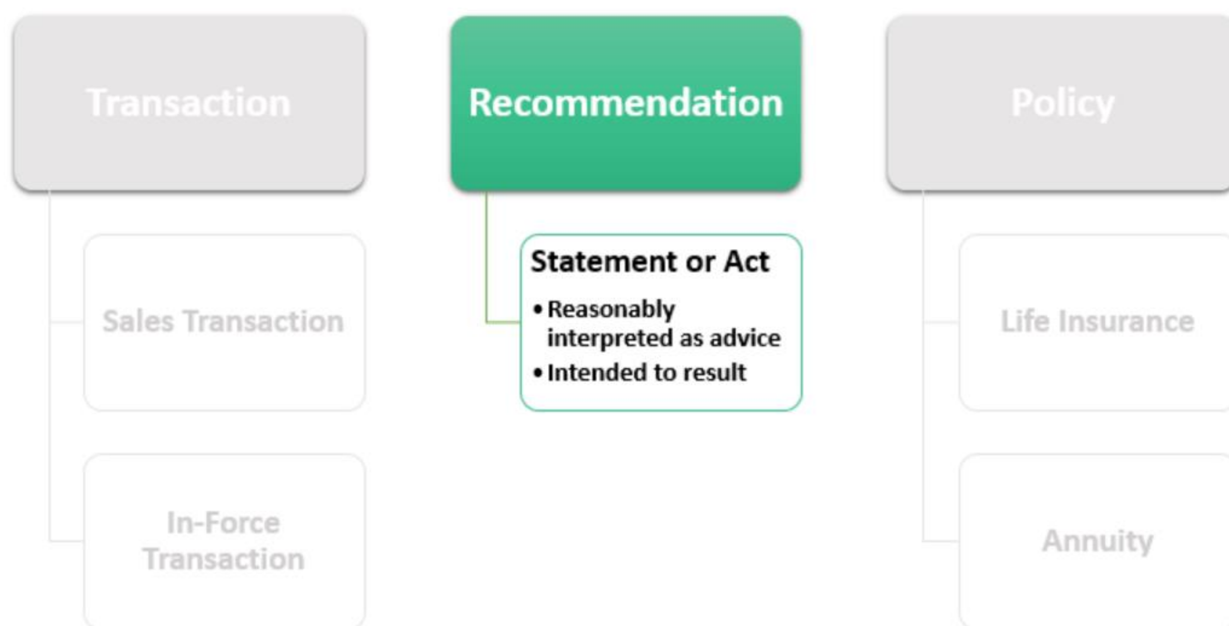
Let's take this a little further and look at a list of activities that Reg 187 explicitly excludes from the definition of recommendation. The following are not considered recommendations:

- Advertisements;
- Marketing materials;
- General education information about insurance, other financial products, or general administrative services;
- Interactive tools that let prospective clients—

- estimate insurance, future income, or other financial needs;
- compare different types of products; or
- refer the client to the producer.

But these exclusions are not foolproof. If your interactive tools do more than let prospective clients explore possibilities on their own, if you use the interactive tools with them as part of the process of making a recommendation, the results could very likely be considered a recommendation. If you compartmentalize your "general education" through social media groups or email lists so that it is, in effect, tailored to the specific situation of the client, calling it "general education" will not exempt you from the requirements of Reg 187. If the client reasonably interprets your communication as advice, Reg 187 will apply.

The key question will be whether you are just giving out general information to the public (not a recommendation) or if you are individually tailoring it (probably a recommendation).




*Knowledge Check*

Which of the following is present in a "sales transaction," but is not present in an "in-force" transaction?

A. A sale **[Your answer is incorrect. Although a sales transaction involves a sale, sales are not specifically excluded from in-force transaction. In-force transactions include any modification or election of a contract provision that does not generate new sales compensation. The rules don't let you off the hook in the case of in-force transactions, but the rules are somewhat relaxed in recognition of the fact that you are not getting specifically compensated for the work.]**

B. A policy **[Your answer is incorrect. Both sales transactions and in-force transactions involve policies. In-force transactions include any modification or election of a contract provision that does not generate new sales compensation. The rules don't let you off the hook in the case of**

**in-force transactions, but the rules are somewhat relaxed in recognition of the fact that you are not getting specifically compensated for the work.]**

**C.** New sales compensation **[Your answer is correct. In-force transactions include any modification or election of a contract provision that does not generate new sales compensation. The rules don't let you off the hook in the case of in-force transactions, but the rules are somewhat relaxed in recognition of the fact that you are not getting specifically compensated for the work.]**

D. Renewal commissions **[Your answer is incorrect. Renewal commissions are not considered "new sales compensation." In-force transactions include any modification or election of a contract provision that does not generate new sales compensation. The rules don't let you off the hook in the case of in-force transactions, but the rules are somewhat relaxed in recognition of the fact that you are not getting specifically compensated for the work.]**

## 3.3 The Policy: Life Insurance, Annuity, Individual, Group

Regulation 187 is a New York Insurance regulation, so it applies only to transactions regulated by the New York Department of Financial Services. So, it does not apply to sales of stocks or bonds or mutual funds—things regulated solely by the federal government.

But its coverage is broad, within the life insurance and annuities field. The regulation uses the word "policy" to define the scope. The word "policy" includes a(n):

- Life insurance policy;
- Annuity contract;
- Certificate issued by a fraternal benefit society;
- Certificate issued under a group life insurance policy; or
- Certificate issued under a group annuity contract.

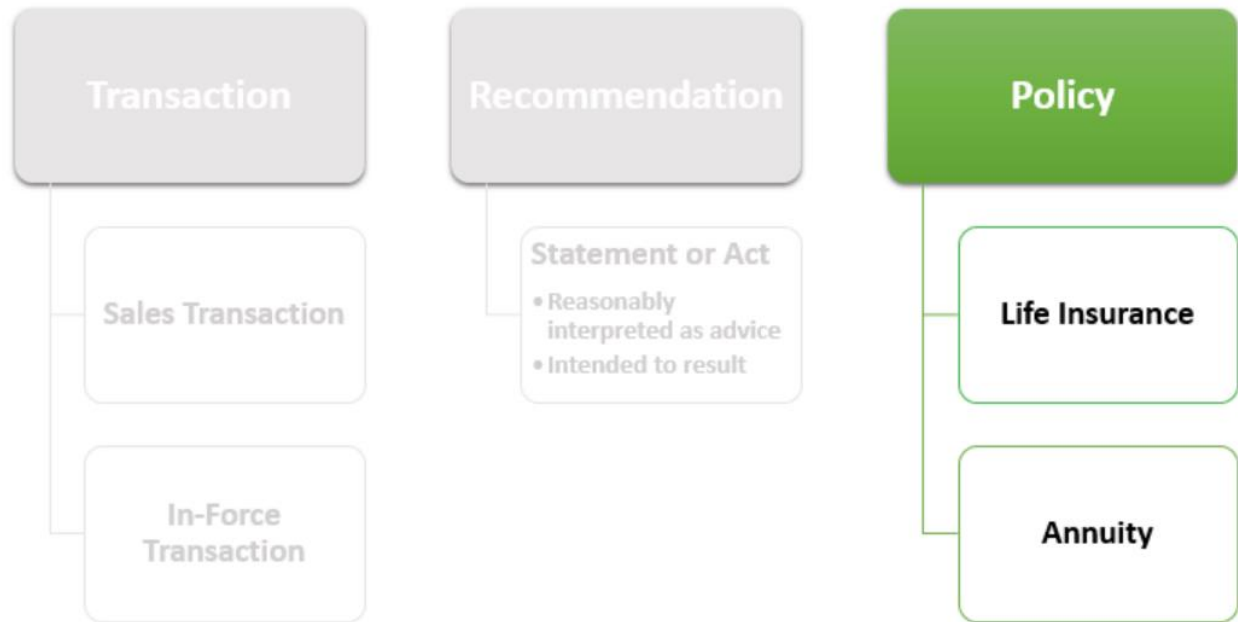
This listing is meant to include all of the following:

- Term life;
- Life policies with small death benefit;
- Group life policies;
- Large policies sold to sophisticated investors through private placements;
- Group annuities;
- Individual annuities; and
- Permanent life insurance.

The reason all of these different types of policies and contracts are covered by Reg 187 is to have a consistent standard across both life insurance and annuity lines. According to the Department of Financial Services, this consistent standard—

> ". . . promotes a level playing field among insurers, is more easily understood by consumers and is more auditable for the department. Consistency across life insurance and annuity product lines also promotes cost savings for producers and insurers who would not have to develop multiple compliance systems and multiple supervision systems."

There are specific exemptions, which we will get to in the next section.




## 3.4 Exempted Transactions

The following transaction are exempt from the requirements of Regulation 187 (but may be subject to other federal or state requirements):

- **Purchase with no recommendation.** Reg 187 does not apply where the application for purchase is received in response to a generalized offer by the insurer by mail, at the worksite, or under other methods without producer involvement (other than customer service, administrative support, or enrollment services) and where no recommendation has been made.
- **Certain retirement, employment-, or litigation-related plans.** Reg 187 does not apply to policies used to fund pension or welfare benefit plans covered by ERISA; other employer-sponsored retirement plans;[6] arrangements to pay liabilities of terminated pension or retirement plans (including terminated portions of ongoing plans); certain retirement or deferred compensation plans maintained by governments, churches, or other tax exempt organizations;[7] nonqualified deferred compensation arrangements of an employer or plan sponsor; or personal injury settlements.
- **COLI or BOLI.** Reg 187 does not apply to any corporate-owned or bank-owned policies on the lives of employees in connection with a benefit plan[8] where substantially all the benefits under the policy are payable to the corporate or bank policy owner.

[6] Under Internal Revenue Code Sections 401(a), 401(k), 403(b), 408(k) or 408(p).
[7] Under Internal Revenue Code Sections 414 or 457.
[8] Authorized by NY Insurance Law Section 3205(d).

- **Credit life insurance and life settlement contracts.** Reg 187 does not apply to credit life insurance sold on a group basis or to any life settlement contract.[9]

So now you know what transactions are subject to Reg 187 and which are not. Let's now turn to what it means to be subject to the reg.

## 4.0 Collecting Suitability Information from Your Client

Earlier in this course we told you that Regulation 187 requires two important things:

- Your recommendations must be suitable for your client; and
- Your recommendations must be in the best interest of your client.

How do you know if your recommendations are suitable and in the best interest of your client? It starts with your fact-finding. You have to know about your clients before you can make recommendations for them.

As you will learn later in this course, the suitability rules for term life insurance are different from the suitability rules for the other products covered by the regulation (permanent life insurance and annuities). This is because term life insurance lacks cash value while the other pr oducts have it. Since your fact-finding is driven by the kind of suitability analysis you will be making, the list of suitability information is different, depending on the type of transaction you will be recommending.

Reg 187 lists specific items that State of New York considers to be appropriate to each kind of recommendation. These may not all be appropriate in all cases. You have to consider your clients' financial situation and the materiality of the factor to the type of transaction being considered. Here are the lists:

| Suitability Information | All policy types EXCEPT term life insurance | Term life insurance ONLY |
|---|---|---|
| Age | X | X |
| Annual income | X | X |
| Financial situation and needs, including the financial resources used for the funding of the policy | X | X |
| Financial experience | X | |
| Financial objectives | X | X |
| Intended use of the policy, including any riders attached thereto | X | X |
| Financial time horizon, including the duration of existing liabilities and obligations | X | X |

[9] Under NY Insurance Regulation 27A or Law Article 78.

| Suitability Information | All policy types EXCEPT term life insurance | Term life insurance ONLY |
|---|---|---|
| Existing assets, including investment and insurance holdings | X | X |
| Liquidity needs | X | |
| Liquid net worth | X | |
| Risk tolerance | X | |
| Willingness to accept non-guaranteed elements in the policy, including variability in premium, [cash value,] death benefit, or fees | X | All items except cash value |
| Tax status | X | |
| Any other information provided by the consumer which in the reasonable judgment of the producer, or the insurer where no producer is involved, is relevant to the suitability of the transaction | X | X |

Both lists of suitability information are extensive. Your firm should provide you with forms that list the required information. Let's take a moment, however, to note what is lacking on the term life insurance list. If you are selling term life, you are not required to collect information on:

- Financial experience
- Liquidity needs
- Liquid net worth
- Risk tolerance
- Willingness to accept non-guaranteed cash value in the policy
- Tax status

All these are related to the investment component of annuities and permanent insurance and are not present in term life insurance.

Two things to keep in mind about the cut-down fact finding for term clients:

- You might not know at the beginning of a case that your client will only need term insurance. Even if the client starts with that question, your recommendation could go beyond that. If so, you could need to collect additional information before making the recommendation.
- If you believe in the strategy of "buy term and invest the rest," you will probably have to collect the additional information to recommend the investment part of the plan.

*Knowledge Check*

Nancy is meeting with a client who is only interested in term life insurance. Which of the following items would not be required in her fact-finding (i.e., not considered an item of suitability information with respect to term life insurance)?

A. Risk tolerance **[Your answer is correct. Risk tolerance is a piece of information related to investment; term life insurance does not have an investment component.]**
B. Time horizon **[Your answer is incorrect. Term life insurance is written for a term of years, so it is essential to know the time horizon in order to be able to write the policy. Risk tolerance is a piece of information related to investment; term life insurance does not have an investment component.]**
C. Age **[Your answer is incorrect. Premiums are based on the age of the insured, so it is essential to get the client's age. Risk tolerance is a piece of information related to investment; term life insurance does not have an investment component.]**
D. Annual income **[Your answer is incorrect. Term life insurance is frequently sold as income replacement for the insured's survivors, so it is essential to know the amount of income replaced. This information is also relevant to the affordability of the premiums. Risk tolerance is a piece of information related to investment; term life insurance does not have an investment component.]**

## 4.1 Client Reluctance to Provide Suitability Information

Not all clients are willing—or able—to provide the type of suitability information you need to provide well-thought-out recommendations. Here are some possible reasons:

- In these days of computer hacking, many people are understandably reluctant to let anyone have their financial information.
- The client may not trust you or may believe that you will not put your interests ahead of theirs, so they tell you as little as possible to get their transaction executed.
- The client may not be familiar with financial concepts or may have lost their capacity to handle financial matters due to illness, injury, or old age. (We discuss diminished capacity later in this course.)

We'll leave the question of your client's diminished capacity to the end of the course. Here we will be discussing the situation of your client's refusal to provide the information you need or the possibility that it might be inaccurate.

Collecting your client's suitability information IS your responsibility, but there is nothing in Regulation 187 that requires you to guarantee that information. Your obligation is to "make reasonable efforts." It's up to your client to comply fully or not. Obviously, it is in their interest to give you the information you need to make a best-interest recommendation. But it doesn't always work out that way.

What is your obligation in such a situation?

According to Reg 187, your best-interest obligation assumes a certain level of cooperation from your client. Under the reg, you have no best-interest obligation to the client in the following circumstances:

- **Refusal**—Your client refuses to provide relevant suitability information and the transaction is not recommended;
- **Material inaccuracies**—You make a recommendation and you later find out that your client provided materially inaccurate material information that you used to make the recommendation (yes, we used the word "material" twice—the reg lets you off the hook only if the information was material to the decision and the inaccuracy was material—tangential inaccuracies should not interfere with your ability to make a good recommendation);
- **Transaction different from recommendation**—Your client decides to enter into a transaction that is different from what you recommended; and
- **No recommendation**—You don't even make a recommendation.

**Working With the Information You Have**

Does this mean you are done if any of these situations arise? No.

Reg 187 says that you "shall not make a recommendation" to a client about which you have inadequate knowledge. This presumably means no recommendation if you don't have adequate knowledge of the client (but it also means you need to have adequate knowledge of the products, as well, which we will be discussing later).

Insurers that make sales to these clients still have an obligation to make sure that the transaction is suitable for the client "based on all the information actually known" at the time of the transaction.

Obviously, a suitability determination would be questionable, at best, if the information is limited or wrong. But some transactions can be ruled out on suitability grounds even on minimal information.

**Verification of Suitability Information by Insurer**

Your client may be contacted by an insurer to confirm the suitability information you collected to make your recommendation. Under Reg 187, you are prohibited from dissuading (or attempting to dissuade) your client from responding truthfully to such a request.

## 5.0 Making the Recommendation

You have collected your client's information. Now we get to the meat of the process: making your analysis and making your recommendation to the client. In making your recommendation, under Regulation 187, you must act in the best interest of your client. What does this mean under the reg?

- **Suitable recommendation.** Your recommendation must be suitable for the client.
- **No conflict of interest.** The transaction is in the best interest of the client taking only the client's interest (and not yours or your firm's) into account.
- **Client informed.** You are required to make a reasonable effort to inform your client of the costs and benefits of your recommendation.

Suitable Recommendation

No Conflicts of Interest

Client Informed

In the next sections, we are going to delve into these requirements. We will be leaving the suitability question to last so we can give you some suitability illustrations for both annuities and life insurance. Let's start with the best interest of the client.

## 5.1 The Best Interest of the Client

Reg 187 requires you to consider only the interest of your client (and no one else). That is what we mean by "no conflict of interest." The reg sees commissions or other compensation or sales incentives as a potential conflict of interest or risk to the best interest of the client. The reg does not prohibit any form of compensation otherwise allowed under the state' insurance laws, however, "provided that the amount of the compensation or the receipt of an incentive does not influence the recommendation."

Regulation 187 does not require you to recommend the least expensive product available. You are required to weigh multiple factors that differentiate products or insurers that are relevant to the best interest of your client.

## 5.2 Informing the Client

The next requirement is to inform the client. This depends on the client and on the complexity of the recommendation. Some clients have a greater capacity to understand financial information than others. The regulation requires a reasonable effort.

What must you try to convey to the client? The features of the policy you are trying to sell them and the consequences of the sales transaction, both favorable and unfavorable.

The regulations list factors that you should communicate, including:

| | | |
|---|---|---|
| • death benefit | • policy exclusions or restrictions | • insurance and investment components |
| • market risk | • guaranteed interest rates | • limitations on interest returns |
| • availability of cash value | • equity-index features | • potential surrender periods and surrender charge |
| • any secondary guarantee period | • potential tax implications if the consumer sells, modifies, surrenders, lapses, or annuitizes the policy | • mortality and expense fees |
| • cost of insurance charges | • investment advisory fees | • potential charges for and features of riders |

| | | |
|---|---|---|
| • any differences in features among fee-based and commission-based versions of the policy | • the manner in which the producer is compensated for the sale and servicing of the policy | |

This list comes verbatim from the regulation, but we rearranged them so that the topics that are easiest to talk about with your client (favorable news) are toward the top and the topics you might be tempted to gloss over (unfavorable news) are at the bottom. Of course, every situation is different. But the rule is that you must give it to your client straight: the bad news with the good. You explain the trade-offs, how you arrived at the recommendation, and why you believe it is the best option for the client.

**Disclosure and Documentation**

All this is required to be written. You are required to provide a disclosure to the client in a "reasonable summary format" all the relevant suitability considerations and product information, both favorable and unfavorable, that provide the basis for any recommendation you make.

In addition, you are required to document, for your files:

- **The basis for your recommendation**, including both facts and analysis that support the recommendation;
- **Any refusal by the client** to provide suitability information; and
- **Decision by client** to make a purchase that you did **not recommend**.

Now, let's move on to the question of suitability.

*Knowledge Check*

All of the following are required when you make a recommendation under Regulation 187 EXCEPT

A. The recommendation is suitable based on the information provided by the client. **[Your answer is incorrect. No guarantee is required. Suitability is required, however. The three main elements of a compliant recommendation are suitability; best interest of client, not the producer; and providing fair information to the client about the recommendation.]**

B. You must provide a guarantee to the client that no money will be lost over the life of the policy. **[Your answer is correct. No guarantee is required. The three main elements of a compliant recommendation are suitability; best interest of client, not the producer; and providing fair information to the client about the recommendation.]**

C. The recommendation may not take into account any sales incentives or other compensation you might receive from the transaction. **[Your answer is incorrect. No guarantee is required. You may not take into account sales incentives or other guarantees, however. The three main elements of a compliant recommendation are suitability; best interest of client, not the producer; and providing fair information to the client about the recommendation.]**

D. You must inform the client the reason for your recommendation and outline both the pros and the cons. **[Your answer is incorrect. No guarantee is required. You must inform the client, however. The three main elements of a compliant recommendation are suitability; best interest of client, not the producer; and providing fair information to the client about the recommendation.]**

## 5.3 General Suitability Requirements

Let's begin this section by looking at what Reg 187 has to say on the topic of suitability:[10]

> *(b) The producer, or insurer where no producer is involved, acts in the best interest of the consumer when:*
>
> ** * **
>
> > *(2) the sales transaction is suitable; and*
> >
> > *(3) there is a reasonable basis to believe:*
> >
> > ** * **
> >
> > > *(ii) the consumer would benefit from certain features of the policy, such as tax-deferred growth of any cash values, annuitization, or death or living benefit;*
> > >
> > > *(iii) the particular policy as a whole, the underlying subaccounts to which funds are allocated at the time of the sales transaction, and riders and similar product enhancements, if any, are suitable for the particular consumer based on the consumer's suitability information.*
>
> * * *

[10] 11 NYCRR § 224.4.

*(c) In making a recommendation, a producer, or an insurer where no producer is involved, may weigh multiple factors that are relevant to the best interests of the consumer including, but not limited to, the benefits provided by the policy, the price of the policy, the financial strength of the insurer, and other factors that differentiate products or insurers.*

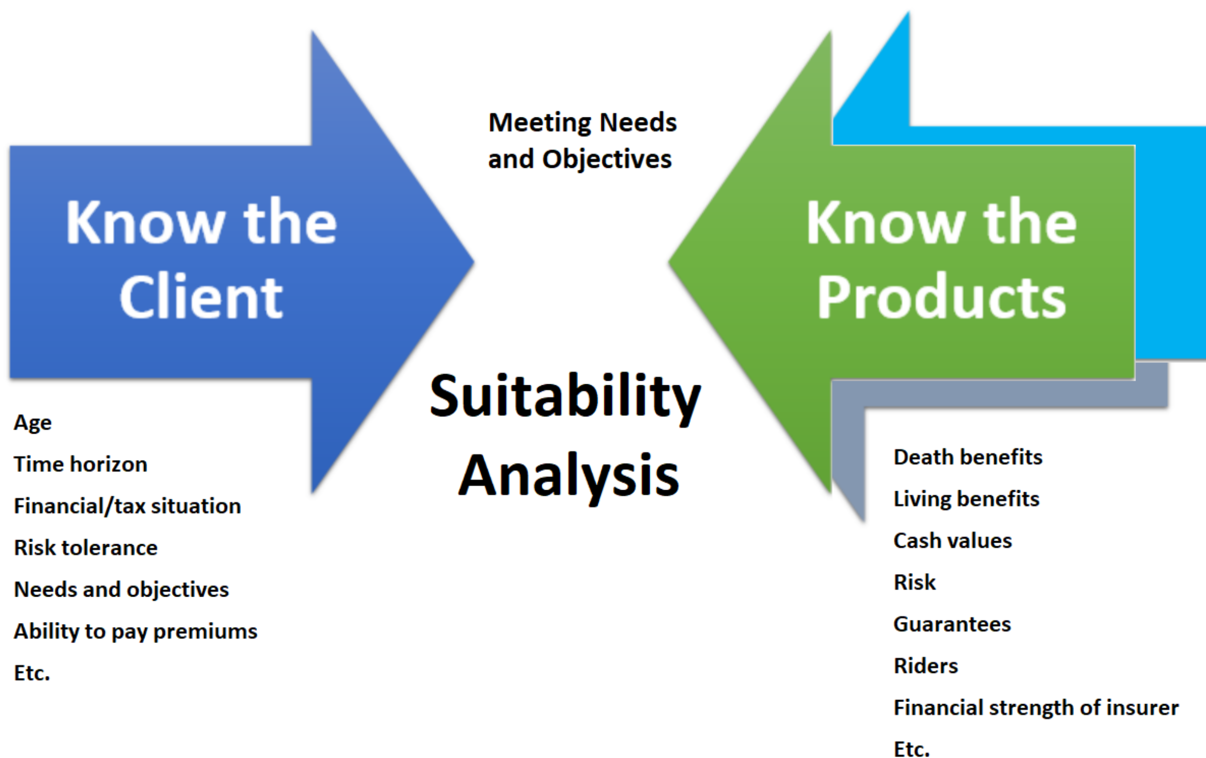
** * **

*(g) A producer shall not make a recommendation to a consumer to enter into a sales transaction unless the producer has a reasonable basis to believe that the consumer has the financial ability to meet the financial commitments under the policy.*

And to complete our analysis of the text of the regulation, let's look at the regulatory definition of suitability:[11]

(*h*) *Suitable means in furtherance of a consumer's needs and objectives under the circumstances then prevailing, based upon the suitability information provided by the consumer and all products, services, and transactions available to the producer.*

What does this mean? Let's break down these requirements into a graphic.




You need to understand your client and the many factors you discover when you collect the required suitability information in your fact finding. You need to understand the costs and benefits of a range of

[11] 11 NYCRR § 224.3.

products so you can sift through them to find the ones that you believe will best meet your client's needs and objectives.

**Limited Product Offerings**

As we just suggested, part of a suitability analysis may entail comparing the features and costs of a variety of products to see how each might satisfy a client's requirements. What if you are restricted from looking at all the products in the market? What if your captive or affiliation agreement with an insurer limits the choices available to your client?

That's okay, under Reg 187, but you must be upfront with your client. Before making any recommendation, you are required to prominently disclose to your client, in a form acceptable to the Department of Financial Services:

- The nature of the agreement you have with the insurer;
- When you will limit the range of policies you will be able to recommend; and
- When you will NOT limit the range of policies you will be able to recommend.

Here are some examples[12] (other situations are possible):

> **Example:** Arnold recommends policies from his primary insurer AAA Insurance, but will recommend policies from other insurers when AAA Insurance doesn't offer a policy that meets her client's needs or objectives.
>
> **Example:** Betty recommends policies from her primary insurer BBB Insurance, but will recommend policies from other insurers when the type of policy that would be in the best interest of the client is not available from BBB.
>
> **Example:** Cheryl recommends policies from her primary insurer CCC Insurance, but will recommend policies from other insurers when CCC's underwriting criteria are not favorable for her client.
>
> **Example:** Don recommends policies from his primary insurer DDD Insurance, but will recommend policies from other insurers when DDD's offer is not acceptable to his client.

Your disclosure to clients must be specific. You can't just use a general disclaimer like "my recommendations may be limited." You disclosure must tell your clients exactly **how** your recommendations will be limited.

**Making the Suitability Determination**

As we discussed earlier, Regulation 187 governs the recommendations you make for two types of contracts: annuities and life insurance. It is beyond the scope of this course to review all the different types of products available to your clients in the annuities and life insurance markets. But we want to give you a framework for both to illustrate the types of analysis needed. Let's begin with annuities.

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[12] Taken from 11 NYCRR § 224.4(m).

## 5.4 Annuity Suitability

We want to stress that, regardless of the type of recommendation you make—annuity or life insurance—your suitability analysis starts with two types of information: information about your client and information about the products that might be available to meet your client's needs and objectives. Let's start with client.

### 5.4.1 Know Your Client

Before making a sale, you are required to have reasonable grounds for believing the recommendation is suitable. And you are required to make reasonable efforts to get the information you need to assess the suitability of your recommendation. We have already reviewed the information Reg 187 wants you to collect, but let's look at the list in another way, focusing on the information you will be using in an annuities suitability analysis.

The information you are looking for includes the client's:

- Financial situation (which usually includes their income and assets)
- Investments,
- Liquidity and liquidity needs,
- Tax status,
- Needs (which could include needs of dependents, special needs due to health status, etc.),
- Investment objectives,
- Age (in relation to desired retirement age),
- Investment time horizon,
- Investment experience, and
- Risk tolerance.

You need to use a fact finder or you will forget something. Each of these checklists is slightly different, but they end up at the same place. You will obviously use your firm's fact finder.

Let your client collect what they can, but have a data-gathering session to help put it all together and answer your client's questions. Really, the more information you have, the better your recommendation will be. All this information should be written and retained in your records.

Your client's need and objectives should naturally drive the analysis, but the following factors are very important in deciding upon any recommendation:

- Liquidity,
- Time horizon,
- Tax status, and
- Tolerance for risk.

**Liquidity and Investment Time Horizon**

Putting money into an annuity ties it up for a period of time. This is due to unfavorable tax treatment of withdrawals, the premature withdrawal tax penalty, and surrender charges. These make annuities illiquid as investments. This means that annuities should be recommended and sold only to clients who have:

- A long investment time horizon, and
- Sufficient short-term resources to meet needs that arise before the client's stated goal (usually retirement).

A client may be considered to have a sufficiently long investment time horizon if their goal does *not* require funds before:

- The client reaches age 59 ½ (thereby avoiding the 10% premature withdrawal penalty),
- The surrender charge period has ended, and
- Sufficient time has passed so that the annuity's tax-deferral benefit outweighs the generally higher fees charge for annuities (particularly variable annuities) compared to alternative investments like mutual funds.

A client who is significantly past retirement age may meet the age 59 ½ point above, but will not likely meet the other two points. In most cases, an annuity is not suitable for such an older client.

*Knowledge Check*

You are reviewing your client Tim's information to determine if his investment horizon is sufficiently long that would make the purchase of a variable annuity suitable. You would look for all of the following EXCEPT:

A. Tim will not require funds from the annuity before age 59½. **[Your answer is incorrect. This is one of the factors that would make a variable annuity purchase suitable. A client with a sufficiently long investment time horizon for purposes of variable annuity suitability is one whose investment objectives are such that the funds are not required before:**
**The client attains age 59½ and, thereby, avoids a 10% premature distribution tax penalty;**
**Any surrender charge period in the variable annuity has ended; and**
**A sufficient holding period has ended so that the tax-deferral benefits of a variable annuity outweigh their generally higher fees and charges when compared to alternative investments, such as mutual funds.]**

B. Tim will not require funds from the annuity before the surrender charge period had expired. **[Your answer is incorrect. This is one of the factors that would make a variable annuity purchase suitable. A client with a sufficiently long investment time horizon for purposes of variable annuity suitability is one whose investment objectives are such that the funds are not required before:**
**The client attains age 59½ and, thereby, avoids a 10% premature distribution tax penalty;**
**Any surrender charge period in the variable annuity has ended; and**
**A sufficient holding period has ended so that the tax-deferral benefits of a variable annuity outweigh their generally higher fees and charges when compared to alternative investments, such as mutual funds.]**

**C.** Tim will not require funds from the annuity before the 10$^{th}$ contract anniversary. **[Your answer is correct. The 10$^{th}$ contract anniversary is not a critical date in this analysis. A client with a sufficiently long investment time horizon for purposes of variable annuity suitability is one whose investment objectives are such that the funds are not required before:**
**The client attains age 59½ and, thereby, avoids a 10% premature distribution tax penalty;**
**Any surrender charge period in the variable annuity has ended; and**
**A sufficient holding period has ended so that the tax-deferral benefits of a variable annuity outweigh their generally higher fees and charges when compared to alternative investments, such as mutual funds.]**

D. Tim will not require funds from the annuity until the contract's tax-deferral benefits outweighed the generally higher costs incident to a variable annuity. **[Your answer is incorrect. This is one of the factors that would make a variable annuity purchase suitable. A client with a sufficiently long investment time horizon for purposes of variable annuity suitability is one whose investment objectives are such that the funds are not required before:**
**The client attains age 59½ and, thereby, avoids a 10% premature distribution tax penalty;**
**Any surrender charge period in the variable annuity has ended; and**
**A sufficient holding period has ended so that the tax-deferral benefits of a variable annuity outweigh their generally higher fees and charges when compared to alternative investments, such as mutual funds.]**

**Tax Status**

One of the important benefits a client gets from an annuity, particularly a variable annuity, is the tax deferral of annuity gain. Tax deferral is more of a benefit with a high-bracket client, however, than with a low-bracket client. So, an annuity may be suitable for a client who:

- Has a relatively high current income tax bracket, such that they can benefit from tax-deferral;
- Anticipates a lower income tax bracket when the funds are distributed; and
- Expects to delay distribution until the benefits of tax-deferral outweigh the higher costs of investing in a variable annuity.

In addition, unless the client is seeking non-tax annuity benefits, they will have taken advantage of other long-term investment vehicles offering additional tax benefits, such as –

- Tax-deductible traditional IRAs;
- Roth IRAs;
- Employer-sponsored 401(k) plans; and
- Employer-sponsored 403(b) tax sheltered annuity plans.

A client who is unable to benefit sufficiently from the tax-deferral offered by a variable annuity because of minimal current tax liability, no anticipation of a lower tax bracket when funds are distributed, or an inability to delay distribution until the benefits of tax-deferral outweigh the higher variable annuity costs may not be suitable.

Furthermore, only if a client is seeking the other, non-tax benefits of variable annuity investing—an income that cannot be outlived, for example—should the client invest in a variable annuity unless they have taken full advantage of the greater tax benefits of alternative investments. To invest in a variable annuity solely for its income tax benefits without first having taken advantage of such alternatives would be unsuitable.

**Risk Tolerance**

Variable annuities are securities; as such, they may expose variable annuity contract owners to investment risk of various degrees, depending on the variable subaccounts selected for investing premiums. Accordingly, in order for a variable annuity to be suitable, you must determine that the applicant possesses a risk tolerance level that is appropriate with respect to investment in both:

- The variable contract; and
- The variable subaccounts selected.

A client with an appropriate tolerance for risk such that a variable annuity is suitable will possess both:

- Financial risk tolerance, i.e., loss of principal will not have catastrophic consequences; and
- Psychological risk tolerance.

While determining whether a client has adequate financial risk tolerance is fairly straightforward and may be discovered by reviewing their financial and personal situation, psychological risk tolerance may be more difficult to determine. A client whose psychological risk tolerance is low—despite being financially tolerant of risk—is one who is likely to worry inordinately about the safety of principal invested in a variable annuity. Variable annuities would be unsuitable for such a client.

Some clients may indicate a desire to allocate all or most of their premiums to a variable annuity's fixed account. Although their making such an allocation would resolve their concern about investment risk, such a decision is inappropriate since they would be better served in other, lower cost investment opportunities—possibly including the purchase of a fixed annuity.

### 5.4.2 Know Your Product

There are certain defining characteristics of each of the different types of annuities. Annuities may categorized as immediate or deferred, single premium or flexible premium, fixed or variable, and qualified or nonqualified. Those characteristics give rise to certain advantages and disadvantages of each type of annuity and bear heavily on their suitability for specific clients.

In this section, we will briefly examine the characteristics, advantages and disadvantages of each of the main types of annuities during their accumulation period and after they have been annuitized. We will begin with a look at declared-rate fixed annuities.

**Suitability of Declared-Rate Fixed Annuities Prior to Annuitization**

**Advantages:** The principal advantages of a declared-rate fixed annuity during its accumulation period are guarantees of:

- Principal, and
- Interest.

In short, a declared-rate fixed annuity does not expose the contract owner to market risk. In addition, insurers, cognizant of the competitive pressures of other savings instruments, generally declare interest-crediting rates that are consistent with other investment alternatives carrying approximately equal risk, such as certificates of deposit.

Finally, all annuities offer contract owners the opportunity to accumulate tax-deferred funds in the cash value. The benefit of such tax deferral is the funds that might otherwise have been used to pay currently due income tax on the credited interest can remain in the cash value and accrue additional interest. Although the income tax liability arises upon distribution of the cash value, the benefits of tax deferral can be significant.

**Disadvantages:** The principal disadvantage of owning any annuity is its inherent illiquidity resulting from surrender charges, LIFO income tax treatment, and possible premature distribution tax penalties. Although the inclusion of crisis waivers may enable a contract owner to avoid surrender charges in certain cases, LIFO tax treatment and tax penalties may still apply.

A significant disadvantage resulting from a declared-rate annuity being a fixed annuity is that its interest crediting may not keep pace with inflation. As a result, the real value of the annuity—its value in terms of purchasing power—may be far less than its cash value.

A disadvantage of declared-rate fixed annuities that is sometimes voiced is such an interest-crediting regimen requires the contract owner trust the insurer to continue to credit competitive interest rates. A contract owner of a declared-rate annuity may have little alternative to staying in the annuity—because of steep surrender charges and the lack of any "bailout" provision—even when the insurer's renewal interest rate is non-competitive. (A bailout provision in a declared-rate annuity permits the contract owner to surrender the contract without incurring surrender charges if the insurer's declared interest rate falls below a specified rate.)

**Suitability of Declared-Rate Fixed Annuities After Annuitization**

**Advantages:** The most obvious characteristic of a fixed annuity during annuitization is its stable, guaranteed payout. Those periodic income payments will never decline, but they will never increase.

When an annuity contract is issued, it contains provisions describing the various settlement options under which the contract owner may receive periodic income payments under life annuity and temporary annuity settlement options. The settlement option provisions contain guaranteed annuity rates.

Since the guaranteed fixed annuity rates contained in the contract are quite conservative, the insurer's current annuity rates are often more favorable. Accordingly, insurers normally issue the settlement option contract with current annuity rates if those rates are more favorable to the contract owner at the time of annuitization.

The tax treatment of periodic payments enables the contract owner to recover their after-tax premiums from each payment on a tax-free basis until the owner's entire cost basis has been recovered. Determining the tax-free portion of the periodic payments involves the calculation of an exclusion ratio.

The availability of death benefits payable to a contingent payee upon the death of the contract owner under an annuity—regardless of the type—depends entirely on the settlement option chosen and the existence of any guarantee. If the contract owner chooses a straight life annuity as the settlement option under which to receive periodic income payments, their death after receiving at least one periodic payment will result in nothing payable to any contingent payee. Settlement options involving term-certain annuities or life annuities with period certain or refund guarantees may cause death benefits to be payable upon the contract owner's death.

**Disadvantages:** The disadvantage of fixed annuitization is that the contract owner's periodic income payment will never increase. That means it is almost certain to lose real value in terms of purchasing power as inflation occurs.

Annuitization may involve other disadvantages regardless of whether the periodic payments are fixed or variable, including:

- Possible loss of liquidity, depending on the settlement option chosen; and
- Loss of control over the funds.

If the contract owner selects a straight life annuity the annuitized funds are fully allocated to provide the promised periodic income payments. For that reason, the contract owner cannot access the annuitized funds other than as periodic income payments; no withdrawals are possible. If the contract owner selects a life annuity with a period certain or refund annuity, they may be able to take the commuted value of the certain period payments depending on the settlement option provisions.

If a term-certain annuity is selected—a fixed period or fixed amount annuity—the contract owner is generally permitted to commute any remaining periodic payments and receive a lump-sum equal to the present value of those future payments. Remember, that option is not available under a straight life annuity or under any life annuity after the certain period or after periodic income payments equal to the amount annuitized have been received.

**Suitability of Index Annuities Prior to Annuitization**

**Advantages:** The advantages of an indexed annuity during the accumulation period, when compared with other forms of savings and investment, are two:

- The deposited principal and a minimum level of interest are guaranteed; and
- The contract owner may earn a higher interest rate depending on the performance of the associated index. No funds are actually invested in any equity product.

**Disadvantages:** Indexed annuities have the same disadvantages found with other annuities, as well as a few that are distinct to Indexed annuities. The disadvantages indexed annuity contracts share with other annuities are limited liquidity due to:

- Surrender charges,
- LIFO income tax treatment, and
- Possible premature distribution tax penalties.

That limited liquidity may be worsened in an indexed annuity by the design of the product and its interest crediting method. Specifically, interest may not be credited in an indexed annuity until the end of its index period—a duration that may be years. As a result, there could be no interest to withdraw during the index period. Further, certain Indexed annuities employ vesting schedules rather than surrender charges. In the case of an indexed annuity with a cliff vesting schedule, no interest may be available for withdrawal even if credited.

Further, equity index interest crediting may not completely reflect the growth of the stock market during the period covered by the index due to:

- The contract's participation rates, cap rates and margins; and
- The failure of the equity index to reflect the entire market or dividends earned by the represented equities.

**Suitability of Index Annuities After Annuitization**

**Advantages:** The advantages and disadvantages of fixed periodic income payments have been enumerated previously and will not be repeated here, even though an indexed annuity contract owner may choose a fixed periodic income payment settlement option. Instead, we will consider the advantages and disadvantages of indexed life annuity periodic income payments.

Although any particular indexed annuity may offer additional guarantees, the principal advantages of indexed life annuity periodic income payments are:

- A guaranteed floor below which periodic income payments will not fall, despite negative index results; and
- Potential increases in periodic income payments resulting from positive changes in the external index.

In short, the advantages of indexing after annuitization are similar to its advantages during the contract's accumulation period: positive changes in the index will produce growth, and a minimum benefit is guaranteed.

**Disadvantages:** The obvious disadvantage of indexed life annuity periodic income payments taken under an indexed annuity settlement option is that the income may decrease from year to year, depending on the movement of the external index. Although the presence of a floor below which periodic payments will not drop offers the contract owner a level of security, the mere fact they may drop as much as 25 percent is a clear disadvantage when compared with fixed periodic income payments.

In addition to this disadvantage specifically attributable to the indexed annuity contract's indexed nature, the other disadvantages of any kind of annuitization are also present:

- Liquidity may be lost; and
- The contract owner's control over the investment may cease.

**Suitability of Variable Products Before Annuitization**

**Advantages:** In addition to the general advantages of annuity ownership that apply to all annuities, such as tax deferral, three distinct advantages are generally found in the ownership of a variable annuity during its accumulation period:

- Investment control is maintained by the contract owner who may manage cash value through the contract's cash value management tools;
- The contract owner can change their investment allocation with the contract without being required to recognize any gain. This facility enables the contract owner to adjust their portfolio to accommodate changes in objectives or risk tolerance without incurring tax liability; and
- The basing of cash value crediting on the performance of the separate account may enable the cash value to accrue real growth in addition to maintaining purchasing power despite inflation.

**Disadvantages:** In addition to the customary annuity disadvantages involving limited liquidity, the specific variable annuity disadvantage relates to its status as a security. Specifically, the contract owner bears the investment risk and may lose some or all the premium invested and any gain.

The shifting of investment risk from the insurer to the contract owner in the case of a variable annuity is a significant suitability issue and must be thoroughly discussed with the applicant before any variable annuity sale. This may be mitigated by the purchase of guarantees, but guarantees cost money and reduce the upside return.

Fees overall for variable annuities can be higher than alternative investments.

**Suitability of Variable Products After Annuitization**

**Advantages:** In addition to the advantages of annuitization that apply to any type of annuity—the partial tax-free receipt of periodic income payments up to basis and a lifetime income, for example—variable annuitization gives contract owners another significant advantage: a chance to maintain their lifestyle despite ongoing inflation.

Since the periodic income payments received under variable annuitization may vary, depending on the performance of the underlying separate account, rising stock market values will tend to increase the contract owner's income. Regularly increasing periodic income payments act as a hedge against inflation by enabling payees to retain their purchasing power and, thereby, maintain their lifestyle.

Certain variable annuity contracts also offer contract owners another advantage: the opportunity to remain in control of the investment and make allocation changes as desired. Although this continued investment control is not characteristic of all variable annuities during annuitization, it is offered under some contracts and may allow the owner to reallocate invested funds to reflect changed risk tolerance and investment objectives.

**Disadvantages:** The principal advantage of variable annuitization gives rise to its principal disadvantage. Specifically, the variability of periodic income payments that offers the contract owner a hedge against inflation also means that their income may decline. Furthermore, unlike the income guarantee in an indexed annuitization, there is no income floor in variable annuitization, unless a guarantee is purchased. So, the payee's income may reduce significantly if separate account investment performance is poor.

In addition to this disadvantage that applies solely to variable annuitization, annuitizing a variable annuity is subject to another disadvantage normally found in other annuities: liquidity may be lost, depending on the settlement option chosen.

*Knowledge Check*

Alberto is 58, he is maxed out on his employer's retirement plan and IRAs and both are invested heavily in stocks, which he follows closely. He owns his home but has a large mortgage. He is married and has two kids in high school who expect to go to college. He has $10,000 in other savings. You are having a discussion with him about a variable annuity. Which of the following correctly states the suitability analysis?

A. Alberto is too old to purchase a variable annuity because at age 58, his investment horizon is too short. **[Your answer is incorrect. Age 58 is not too old to purchase a variable annuity. Alberto's savings are tied up in qualified plans and his home and he will soon have two kids in college. He needs more liquidity, not less.]**
B. Alberto is not a good prospect for a variable annuity because he has considerable current cash needs and very little in liquid assets. **[Your answer is correct. Alberto's savings are tied up in**

**qualified plans and his home and he will soon have two kids in college. He needs more liquidity, not less.]**

C. Alberto is a good prospect for a variable annuity because he has taken advantage of his tax-qualified plans and needs additional tax shelter. **[Your answer is incorrect. The need for tax shelter is not as important as his liquidity need. Alberto's savings are tied up in qualified plans and his home and he will soon have two kids in college. He needs more liquidity, not less.]**

D. Alberto is a good prospect for a variable annuity because he has a high risk tolerance. **[Your answer is incorrect. Alberto's savings are tied up in qualified plans and his home and he will soon have two kids in college. He needs more liquidity, not less.]**

This discussion just scratches the surface of suitability analysis for annuities. Each client and each product has its own nuances. Adding riders and guarantees adds to the complexity. It is up to you to understand all of this to make good recommendations for your clients.

Now, let's take a look at the topic of suitability as it relates to life insurance.

## 5.5 Life Insurance Suitability

Life insurance suitability builds on the same concepts we talked about in the last section: know your client and know your product. But, of course, life insurance is a different type of product from an annuity. So let's begin with the defining feature of life insurance before we get into the variation.

As before, this discussion is necessarily general, to illustrate the processes of finding suitable recommendations for your clients.

### 5.5.1 Need for a Death Benefit

The need for a death benefit must be the driving force behind a sale of any of these policies. If your client has the needs of his beneficiaries covered in some other way, you probably should not be talking about life insurance.

But most likely, your client will have a need for a death benefit. These needs change through life:

- **A young adult** who is single and without children or other dependents may only be concerned with paying final expense and debts—if they are concerned at all. Many millennials carry a heavy student loan debt that could pass to their parents or spouse at their deaths. Few young adults think about what might be their life insurance needs in a later stage of life. But getting started earlier usually means lower premiums.
- **A breadwinner** (with or without a spouse) who has young children may suddenly realize that their death could be a serious blow to the well-being of their family. A decent death benefit could provide income for the family, pay off debts, provide an emergency fund, pay education expenses, and more.
- **A retiree** may no longer have children to support, but if they are married, the spouse could still have significant needs if the retiree dies. Retirement savings can, of course, be set up to provide for a surviving spouse, but life insurance proceeds could prove valuable to cover late retirement expenses for the survivor. At this stage of life, your client may also have a desire to provide for grandchildren.

The death benefit of all types of life insurance should meet these needs. Term life insurance provides only a death benefit. It is more affordable for young people, but the cost goes up as the client gets older.

Permanent insurance, of varying types, also provides a death benefits, but it provides a savings component as well, which we will discuss in the next section.

The important thing in working with clients is to do an assessment of your client's financial situation to determine what level of death benefit will be desired and balance that with the affordability of the premiums necessary to achieve that goal.

### 5.5.2 Need for Lifetime Benefits—Cash Value

If your client needs only the death benefit, term insurance could work just fine. If your client has a need for lifetime benefits, and is able to afford the premiums, permanent insurance could be a suitable option as permanent insurance provides lifetime benefits as well as death benefits. In this section, we will take a very brief look at the advantages and disadvantages of whole life, variable life, and indexed life, because each type reflects a different approach in regard to risk.

#### Knowledge Check

Providing resources to cover a spouse's late retirement expenses is a good reason for wanting a death benefit for

A. A young adult **[Your answer is incorrect. Although providing later retirement expenses for a spouse may be most important for a retiree, it is valuable for all of these.]**
B. A middle-aged breadwinner **[Your answer is incorrect. Although providing later retirement expenses for a spouse may be most important for a retiree, it is valuable for all of these.]**
C. A retiree **[Your answer is incorrect. Although providing later retirement expenses for a spouse may be most important for a retiree, it is valuable for all of these.]**
D. All of these **[Your answer is correct. Although providing later retirement expenses for a spouse may be most important for a retiree, it is valuable for all of these.]**

**Whole Life Advantages and Disadvantages**

Whole life insurance is a type of permanent insurance that has a constant premium for life, provides a death benefit, and accumulates cash value over time. Purchasing a whole life insurance policy involves many advantages and some disadvantages. No particular whole life policy is always better than another. The selection of a policy to recommend involves matching the client's personal circumstances and life insurance needs with the features and benefits of the policy.

The advantages normally associated with whole life insurance are:

- Forced savings,
- Significant guarantees,
- Permanent protection, and
- A high level of safety.

**Forced Savings**

One of the hallmarks of whole life insurance is the creation of a guaranteed cash value that may be accessed by a policyowner through policy loans or withdrawals. Although the cash value is an integral

element of the life insurance policy, its presence amounts to a forced savings plan put in place by the purchase of a whole life insurance policy.

**Significant Guarantees**

In a whole life insurance policy, the insurer guarantees that the:

- Premiums will not increase beyond those specified in the policy;
- Policy's cash value will be as stated in the policy's guaranteed cash value tables;
- Death benefit shown in the policy will be paid upon the insured's death while the policy is in force; and
- Policy will remain in force provided billed premiums are paid when due.

**Protection Is Permanent**

The insurance protection provided by a whole life policy is permanent. The policy is guaranteed to remain in force for the insured's entire lifetime—irrespective of how long or short that lifetime turns out to be—provided the premiums are paid when due.

**High Degree of Safety**

A whole life insurance policy offers the policyowner unparalleled safety. Although the guarantees provided under a fixed whole life insurance policy are secured by the general assets of the issuing insurer—requiring that the insurer maintain solvency to be able to meet those guarantees—state insurance regulators oversee the operations and financial condition of insurers domiciled in their state.

In the event an insurer is deemed by the regulators to be in trouble, its operations are taken over by the insurance department. If an insurer becomes insolvent and fails, the guarantee fund established by each state helps ensure benefits are paid as and when promised.

**Disadvantages of Whole Life**

Although whole life insurance has many advantages, it also has several disadvantages.

- **Purchasing Power Risk.** As we noted earlier in this course, the rate paid on the cash value in a whole life policy tends to be low. Funds may not be drawn from the cash value for many years during which inflation may erode the funds' purchasing power. The rate paid may not be sufficient to keep pace. Purchasing power risk may be addressed with greater returns available with variable or indexed policies, but that introduces market risk, which we will discuss later in this chapter.
- **Inflexibility in Premiums and Death Benefits.** In a whole life insurance policy, premiums must be paid by the end of the premium grace period—usually no more than 30 days following the premium due-date—or the policy will lapse. Furthermore, a policyowner's attempt to increase or decrease a fixed whole life insurance policy's death benefit may be fairly complicated. If a policyowner wishes to increase the death benefit, they must generally purchase a new life insurance policy. If a decrease in the whole life insurance policy's death benefit is needed, the policy must be changed and re-written. This inflexibility may be addresses with a universal life product.

- **Whole Life May Be Unaffordable.** Although insurers offer various types of whole life insurance with different premium structures—limited payment life, graded premium whole life, modified premium whole life, etc.—the generally higher premiums required for whole life insurance may make such a purchase unaffordable for some individuals. The affordability question may be addressed with a universal product.

Knowledge Check

Which of the following would be considered a DISADVANTAGE of whole life insurance?

A. It may be unaffordable **[Your answer is correct. Unaffordability is a disadvantage.]**
B. It forces the insured to save **[Your answer is correct. Unaffordability is a disadvantage. Forced savings is considered an advantage.]**
C. It contains significant guarantees **[Your answer is correct. Unaffordability is a disadvantage. The guarantees are an advantage.]**
D. The protection is permanent **[Your answer is correct. Unaffordability is a disadvantage. Protection cannot be withdrawn if the insured becomes uninsurable.]**

**Universal Life Advantages and Disadvantages**

Whole life lacks flexibility. Clients who may have a problem meeting the regular premium schedule of whole life might do better with a flexible premium product: namely, universal life. Owning any type of universal life insurance involves both advantages and disadvantages. In addition, owning certain specific sub-types of universal life insurance—*variable* or *indexed* universal life insurance, for example—involves other advantages and disadvantages. Let's consider the advantages and disadvantages of owning a universal life insurance policy of any type.

**Advantages of Universal Life**

The principal advantages of universal life insurance ownership relate principally to the flexibility such policies afford. In these policies, the policyowners are free to:

- Determine how much premium to pay and when to pay it. They may also choose to skip premium payments; and
- Change the death benefit level and option.

Because of that flexibility, a universal life insurance policy can be changed as needed to meet the policyowner's changing life insurance needs and ability to pay premiums.

**Disadvantages of Universal Life**

Universal life insurance policies involve certain disadvantages. Among those disadvantages are the following:

- Policyowners bear the risk of adverse mortality and expense trends that they don't bear when purchasing whole life insurance;

- Barring any secondary guarantees (which may be added by rider), no particular level of universal life insurance premium payments is guaranteed to keep the policy in force for the insured's entire lifetime; and
- A policyowner's surrender of a universal life insurance policy during the policy surrender period may result in the imposition of substantial surrender charges.

### Knowledge Check

Which of the following would be considered an ADVANTAGE of universal life insurance?

A. Policyowners bear the risk of adverse mortality and expense trends. **[Your answer is incorrect. The risk of adverse mortality and expense trends is a DISADVANTAGE. One of the big advantages of universal life insurance is the ability to adjust premium payments as needed.]**

B. Surrender of the policy during the surrender period may result in substantial surrender charges. **[Your answer is incorrect. Surrender charges are a DISADVANTAGE. One of the big advantages of universal life insurance is the ability to adjust premium payments as needed.]**

C. Barring secondary guarantees, no particular premium level is guaranteed to keep the policy in force for the insured's entire lifetime. **[Your answer is incorrect. Lack of a guaranteed premium to keep the policy in force is a DISADVANTAGE. One of the big advantages of universal life insurance is the ability to adjust premium payments as needed.]**

D. Policyowners are free (within limits) to determine how much premium to pay and when to pay it. **[Your answer is correct. One of the big advantages of universal life insurance is the ability to adjust premium payments as needed.]**

### Advantages and Disadvantages of Variable Universal Life Insurance

Whole life insurance accumulates cash value at a fixed rate of interest. It is low but guaranteed. Some clients may be interested, however, in trading away the guarantee in hopes of getting a better rate. Variable life insurance makes this possible in a similar way that variable annuities allow annuity investors to access the possibility of market gains in exchange for the acceptance of market risk. Instead of a guaranteed interest rate, clients who buy variable life insurance can direct the investment of their cash values in a variety of investment subaccounts. And variable life insurance can be combined with the premium flexibility of universal life insurance.

In addition to the general advantages and disadvantages of universal life insurance policy ownership, variable universal life insurance ownership—because of its investment-based cash value—involves other advantages and disadvantages. The principal advantage of owning a VUL policy is that the allocation of premiums and cash values to the insurer's separate account may result in enhanced cash value increases based on investment performance.

The principal disadvantage of VUL ownership relates to its lack of cash value guarantees. In a VUL policy where premiums are allocated to a separate account:

- No minimum interest guarantees apply; and
- Principal and previously-credited interest may be lost.

### Advantages and Disadvantages of Indexed Universal Life Insurance

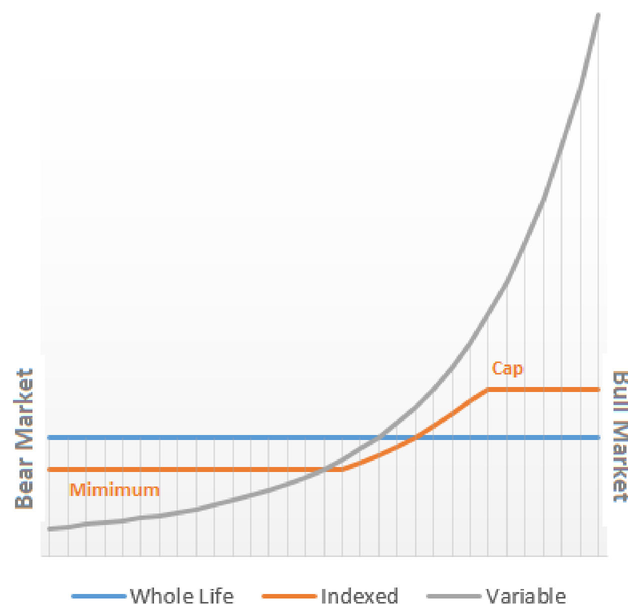
Ownership of an indexed universal life (IUL) insurance policy, because it is a universal life insurance product, involves the previously-noted advantages and disadvantages associated with any universal life insurance policy. However, its use of an external index—such as the S&P 500 Index—as the basis of interest crediting gives rise to additional advantages and disadvantages.

The principal advantage of indexed interest crediting is that it permits an indexed universal life insurance policyowner to participate in some of the positive returns associated with a rising stock market while, at the same time, shielding principal and previously-credited interest from loss due to weak index performance. The principal disadvantages of owning an indexed universal life insurance policy are its:

- Complex structure; and
- Lower guaranteed interest rates compared to those guaranteed in a declared rate product like whole life.

**Comparison of the Investment Characteristics**

Before we leave this topic, we'd like to show you graphic comparing the very-general investment characteristics of whole life, variable life, and indexed life.




In creating this graphic, we deliberately left off any numbers. The exact numbers depend on the specifics of each policy.

- One whole life policy can be different from another, depending on the interest rate used.
- One variable life policy can be different from another, depending on the investment funds chosen by the insured.
- One indexed life policy can be different from another, depending on the index selected.

But the general points of the graphic must be kept in mind.

- The return in a whole life policy is guaranteed, regardless of the state of the market.

- A variable life policy could experience large gains in a bull market, but risks losses in a bear market.
- The return in an indexed life policy may increase in a bull market, but generally not as much as in a variable life policy and large gains are eliminated due to a cap on the rate for crediting interest. In a bear market, returns sink to below whole life, but are prevented from sinking into loss territory by a minimum rate guarantee.

### Knowledge Check

In which of the following permanent insurance types is it possible to lose principal in the cash value account(s)?

A. Variable universal life **[Your answer is correct. Variable life insurance offers the possibility of investing in equity funds, but these may lose money if the market goes down.]**
B. Whole life **[Your answer is incorrect. Variable life insurance offers the possibility of investing in equity funds, but these may lose money if the market goes down. The return on cash value in a whole life policy is guaranteed.]**
C. Indexed universal life **[Your answer is incorrect. Variable life insurance offers the possibility of investing in equity funds, but these may lose money if the market goes down. The return on cash value in an indexed policy may vary with changes in an equity index, but guarantees prevent a loss.]**

This has been a very general discussion. As Reg 187 requires you need to consider all the factors:

- Will the client benefit from the features of the policy, the death benefit, the tax deferred growth of cash values, living benefits (and in the case of an annuity product, annuitization)?
- And will the client benefit from the policy as a whole, including the subaccounts (if any) and riders or other product enhancements.

This determination is made based on the features of the actual policies you are considering, not on the general discussions in this course. The discussion in this course just illustrates the factors you would consider. And these products must be suitable based on the suitability information you received from the client.

Before we leave the topic of your best-interest obligation to your client, we will discuss some special cases situations under the best interest standard:

- Special rules for term insurance,
- Special rules for in-force transactions,
- Special rules for replacement transactions, and
- Special rules for senior clients.

## 6.0 Special Rules for Term Insurance

We've already talked about how term life insurance differs from other products under Regulation 187. The difference comes in how you conduct a fact-finding. The reg lists fewer items you need to know

before making a recommendation of term life insurance. Let's review the chart of suitability information we saw earlier in the course.

| Suitability Information | All policy types EXCEPT term life insurance | Term life insurance ONLY |
|---|---|---|
| Age | X | X |
| Annual income | X | X |
| Financial situation and needs, including the financial resources used for the funding of the policy | X | X |
| Financial experience | X | |
| Financial objectives | X | X |
| Intended use of the policy, including any riders attached thereto | X | X |
| Financial time horizon, including the duration of existing liabilities and obligations | X | X |
| Existing assets, including investment and insurance holdings | X | X |
| Liquidity needs | X | |
| Liquid net worth | X | |
| Risk tolerance | X | |
| Willingness to accept non-guaranteed elements in the policy, including variability in premium, [cash value,] death benefit, or fees | X | All items except cash value |
| Tax status | X | |
| Any other information provided by the consumer which in the reasonable judgment of the producer, or the insurer where no producer is involved, is relevant to the suitability of the transaction | X | X |

Let's take a moment, however, to recall what is lacking on the term life insurance list. If you are selling term life, you are not required to collect information on:

- Financial experience
- Liquidity needs
- Liquid net worth
- Risk tolerance

- Willingness to accept non-guaranteed cash value in the policy
- Tax status

This means you are off the hook for collecting suitability information related to cash accumulation. Term policies don't have cash accumulations, so why would you collect this type of information?

The question is: do you know that you will only be recommending term life insurance from the beginning. If the answer is yes, you can skip this part of the fact-finding. But if you are not sure, you might not be able to skip it.

It probably depends on why your client is looking to buy term insurance. Term insurance to pay off a specific debt, like a mortgage or student debt, probably does not required the same level of analysis as whole life. The client may come to you seeking term coverage.

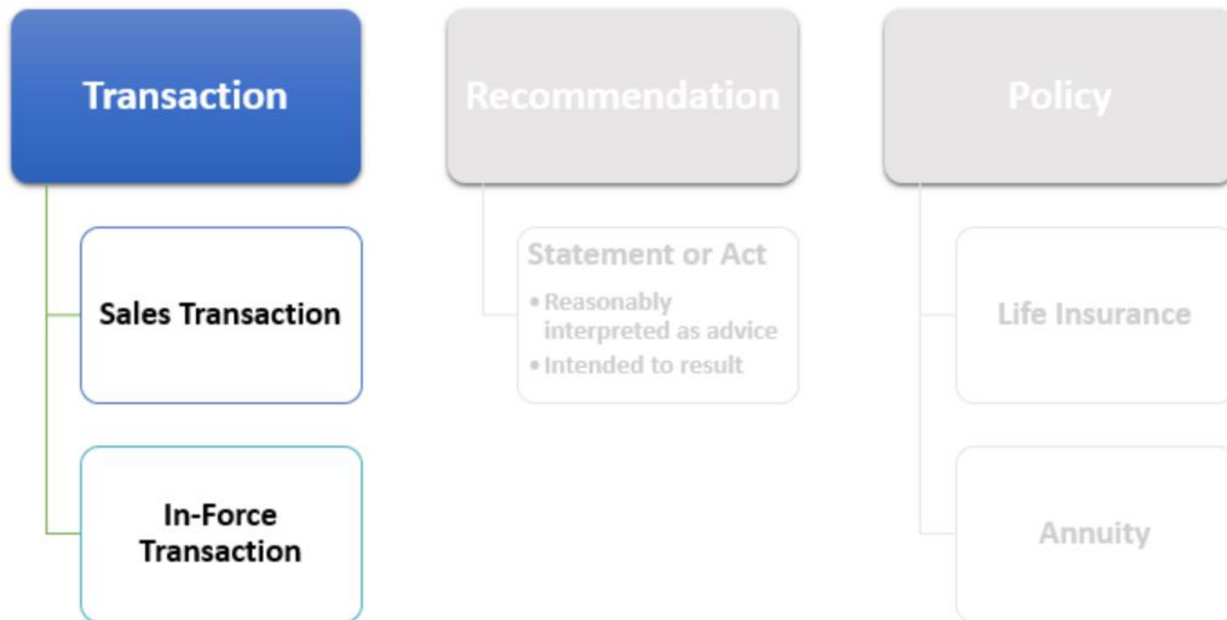
You still are required to make a recommendation in the best interest of the client, however. According to the Department of Financial Services, while term life insurance does not include an "investment component," these policies do allow significant choices that you must evaluate in the best interest of the client, including:

- Length of the term;
- Amount of coverage, including automatic increases or decreases;
- Selection of the carrier (including determining the financial strength of the issuing company);
- Price, including comparison to the price of non-term options that might meet the client's needs and budget; and
- Desirability and value of riders, such as waiver of premium, children or spousal coverage, accelerated death benefit, return of premium, and conversion options.

Furthermore, term insurance comes with the same compensation incentives as other life insurance and annuity products covered by Reg 187. You are required to make your recommendations to clients solely in their best interest, without consideration of your own compensation or other interests.

## 7.0 Special Rules for In-Force Transactions

Recall that Regulation 187 makes a distinction between sales transactions and in-force transactions. Sales transactions include initial issuance of a policy or contract, replacement transactions (discussed later), conversions, modifications, or elections with respect to an in-force policy **if they generate new sales compensation**. (Renewal commissions are not considered "new sales compensation.")




New sales compensation is the issue with in-force transactions and pretty much define in-force transactions because of the **lack** of such compensation. Reg 187 recognized that certain services must be performed with respect to in-force transactions for which you may not be compensated. You are not off the hook for these activities, but there is a difference.

**What Is Not Required.** For sales transactions, an important and time-consuming step is getting the client's suitability information. You are not required to do this for in-force transactions. Presumably, of course, this was already done. You don't have to start over. And you don't have to put together a disclosure or other documentation like you would be required to do for a sales transaction.

**What Is Required.** Even without the fact-finding and the documentation, you still owe three main duties to your clients in in-force transactions:

- **Be informed**. Even though you are not required to do the full fact-finding, etc., you still have an obligation to be informed. This may be based on reading the relevant portions of the client's file or whatever it takes. The regulation prohibits recommendations regarding in-force transactions if you have "inadequate knowledge."
- **Best interest.** Recommendations must still be in the client's best interest. You must use the care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use under the circumstances then prevailing. You are required to consider only the interests of the client. Any compensation or incentive you might receive should not be a factor in making the recommendation.
- **Client is informed.** You need to have a reasonable basis to believe that your clients have been reasonably informed of the features of the policy that are relevant to the in-force transaction and both the pros and the cons of doing the transaction.

The insurer of the in-force policy is required to provide the client all policy information they reasonably request.[13]

We've now talked about two situations in which the rules of Regulation 187 are relaxed somewhat: the sale of term life insurance and in-force transaction. We are now turning to two situations in which your obligations may be heightened: replacement transactions and transactions involving senior clients. Let's start with replacement transactions.

*Knowledge Check*

Which of the following is NOT required when making a recommendation regarding an in-force transaction?

A. You are required to have adequate knowledge to make the recommendation. **[Your answer is incorrect. The regulation prohibits making recommendations regarding in-force transactions if you have "inadequate knowledge." You are not required to start over, however. You can rely on existing information, if you have access to it and need it.]**
B. You are required to use the care, skill, prudence, and diligence a prudent person would use under the circumstances. **[Your answer is incorrect. You are required to use the care, skill, prudence, and diligence a prudent person would use under the circumstances. You are not required to do a fact-finding. You can rely on existing information, if you have access to it and need it.]**
C. You are required to conduct a fact-finding to collect the client's suitability information. **[Your answer is correct. You are not required to do a fact-finding. You can rely on existing information, if you have access to it and need it.]**
D. You must have a reasonable basis to believe that your client has been informed of the pros and cons relevant to the in-force transaction. **[Your answer is incorrect. You are required to believe your client has been informed. You are not required to do a fact-finding. You can rely on existing information, if you have access to it and need it.]**

## 8.0 Special Rules for Replacement Transactions

What is a replacement transaction? And why does Regulation 187 contain specific requirements for this type of transaction. A replacement transaction is a possibility when you make a sale to a client who already has an existing life insurance policy or annuity contract. Let's begin by looking at exactly what we mean by replacement.[14]

A replacement transaction occurs when you sell a new life insurance policy or annuity contract knowing that a client's existing life insurance policy or annuity contract has been or likely will be:[15]

[13] 11 NYCRR § 224.6(g).
[14] Regulation 187 incorporates the definition of replacement used in Regulation 60, 11 NYCRR 51.
[15] 11 NYCRR 51.2(a).

- lapsed, surrendered, partially surrendered, forfeited, assigned to the insurer replacing the life insurance policy or annuity contract, or otherwise terminated;
- changed or modified into paid-up insurance; continued as extended term insurance or under another form of nonforfeiture benefit; or otherwise reduced in value by the use of nonforfeiture benefits, dividend accumulations, dividend cash values or other cash values;
- changed or modified so as to effect a reduction either in the amount of the existing life insurance or annuity benefit or in the period of time the existing life insurance or annuity benefit will continue in force;
- reissued with a reduction in amount such that any cash values are released, including all transactions wherein an amount of dividend accumulations or paid-up additions is to be released on one or more of the existing policies;
- assigned as collateral for a loan or made subject to borrowing or withdrawal of any portion of the loan value, including all transactions wherein any amount of dividend accumulations or paid-up additions is to be borrowed or withdrawn on one or more existing policies; or
- continued with a stoppage of premium payments or reduction in the amount of premium paid.

What does all this mean? It means that the definition or replacement is quite broad. It means that, if you are making a sale and your client is relying on one of these ways to get funds from an existing contract to pay for the new one, you are doing a replacement transaction and a heightened standard applies to you.

You may already be familiar with Regulation 60, from which this definition was taken. Replacement transactions are not always a problem, but they are always suspect, because, if your client already has a life insurance policy or an annuity contract, then there has to be a pretty good reason to dump the old one and get a new one.

Your compensation is not considered a good reason—under either Reg 60 or Reg 187. But that is the risk that restrictions on replacements is meant to address: the possibility that you might not be acting in the best interest of the client.

If you are working on a replacement transaction, you have two sets of requirements to meet: one is the suitability and best interest analysis you must perform under Reg 187, and the other is a procedural requirement of Reg 60. Let's see what is required.

## 8.1 Suitability and Best Interest for Replacement Transactions

Recall all the factors we discussed earlier in the course that you are required to take into account, as appropriate, when you analyze the suitability of the recommendations you make. When your proposed transaction involves a replacement there are some additional factors you must consider in determining suitability:

- **Consider the costs of the transaction.** Will your client incur a surrender charge, increased premium or fees, decreased coverage duration, decreased death benefit or income amount, adverse change in health rating, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living or other contractual benefits), be subject to tax implications if the consumer surrenders or borrows from the policy, or be subject to increased fees, investment advisory fees, premium loads or charges for riders and similar product enhancements?

- **How would the client benefit from the change?** Would the client benefit from policy enhancements and improvements, such as a decreased premium or fees, increased coverage duration, increased death benefit or income amount?
- **How often is the client participating in a replacement transaction?** It is not unreasonable to replace a policy that a client has had for many years. People's life circumstances change. But frequent replacement, in particular, a replacement within the preceding 36 months, can suggest a transaction that is not in the best interest of the client.

In addition to enhanced suitability requirements, the risk of replacement transactions require additional paperwork, to ensure the transaction is proper. That is detailed in Reg 60.

## 8.2 How Replacements Affect the Application Process

Avoiding problems with replacement transactions is so important that the State of New York requires your client to sign a form stating whether a replacement is involved in any application for life insurance or annuity contract. This form is designed to uncover replacement transactions whether you know about the replacement or not. The form describes what a replacement is (the definition we gave you at the beginning of this section) and asks the client to check yes or no to each point.

If no replacement is identified, the replacement procedure is complete. If a replacement is involved, however, a more extensive process is required.

**Once a Transaction Is Identified as a Replacement**

The reason a more extensive process is required (beyond the best interest of your client) is that a larger cast of characters is involved when a replacement is proposed. A normal (i.e., nonreplacement) transaction involves you, your client, and the insurance company. But a replacement transaction involves a second insurer, the issuer of the policy or contract that is proposed to be replaced.

**Notice to Replaced Insurer**

When a life insurance policy or annuity contract replacement has occurred or is likely to occur, you, as the agent or broker involved, are required to get a list of the life insurance policies and/or annuity contracts that are proposed to be replaced. You must then:

- **Notify** the insurer whose life insurance policy or annuity contract is being replaced of the proposed replacement; and
- **Submit** to the insurer whose policy or contract is being replaced –
    - **A list of the policies and/or contracts** you propose to replace and their policy or contract numbers,
    - **An authorization form, signed by the applicant**, giving the insurer authority to disclose information to you concerning the applicant's policies or contracts, and
    - **A request for the information** needed to complete the disclosure statement with respect to the policies or contracts proposed for replacement.

**Response from Replaced Insurer**

The insurer whose contract is proposed for replacement then has 20 days to provide you with the requested information. The insurer also provides the information to agent of record on the to-be-replaced policy or contract.

**Disclosure Statement and Notice to Client**

Before you deliver the new policy or contract to your client, you are required to prepare and deliver to your client a disclosure statement comparing the costs and benefits of the new versus the replaced contract and a notice warning the client of potential problems with replacement transactions. The disclosure is based on the information you received back from the proposed replaced insurance company. You are required to compare a variety of values currently, 5 years out, and 10 years out.

This information is given to the client with a notice that warns them that replacements may not be in their best interest and listing reasons why. The notice urges the client to consult with the agent who sold them the existing policy or contract, tax advisors, or otherwise determine if the proposed transaction is in their best interest. The notice also informs the client that they would have 60 days to back out of the transaction—but also warns them that it could be difficult to restore the original policy if they change their minds.

This Reg 60 procedure is quite detailed.[16] Your firm will have forms and procedures to help you through it.

Before we leave this topic let's take a closer look at the replacement suitability issue as it relates separately to annuities and life insurance.

## 8.3 Suitability and Best Interest of Annuity Replacements

The point of what we have been saying so far is that the replacement of an annuity requires additional vigilance about the suitability of the transaction and making sure it is in the best interest of the client. Sometimes replacing an existing variable annuity, for example, with a newer variable annuity is appropriate; often it is not.

Replacements of annuities also require compliance with specific tax rules, found in Section 1035 of the tax code, so that the transaction is a tax-free exchange. In this section, we discuss the wisdom of doing the transaction at all—in other words, the suitability of the replacement.

**Annuity Replacement Suitability Issues**

Replacement of an annuity must result in a demonstrable net benefit to your client. If you cannot demonstrate that such a client benefit would result, the transaction is unsuitable. The following suitability issues should be considered in every annuity exchange:

- Annuity contract surrender charges and surrender charge periods under both the existing annuity and the proposed replacement, and
- The possible loss of guarantees under the existing annuity.

Before we get into details, it is important to stress that the reason the state of New York adopted Reg 60 is the problem of producers doing replacement transaction more for their own benefit in additional

[16] The Reg 60 procedure is incorporated into Reg 187 by reference. 11 NYCRR 224.6(i).

commission that for the benefit of the client. In other words, replacement transactions have a serious risk of **not** being in the client's best interest.

Let's now briefly review the suitability issues, and then we will consider valid reasons for replacing an annuity. But always keep in mind the best interest requirement as well.

### 8.3.1 Surrender Charges and Surrender Charge Periods

With respect to surrender charges and surrender charge periods—issues that impact heavily on the annuity's liquidity—you need to be cognizant of the surrender charge provisions in:

- The contract being replaced; and
- The replacement contract.

The question that needs to be borne in mind, particularly in connection with surrender charges, is whether the client will obtain a net benefit as a result of the replacement.

If the annuity contract being replaced has a high surrender charge, such a replacement would be very costly for the contract owner. Alternatively, if the existing annuity is no longer in the surrender charge period, replacing it with an annuity that imposes a new surrender charge would appear to adversely affect the client's liquidity. Although the presence of surrender charges is clearly an issue that looms large in the replacement suitability assessment, their simple presence is only one factor in determining the suitability of a variable annuity replacement.

### 8.3.2 Loss of Existing Guarantees

It should be clear that any guarantees contained in the variable annuity contract being replaced would be lost. Among the possible guarantees that would be lost in a replacement transaction are:

- Death benefit guarantees; and
- Guarantees under guaranteed living benefits provisions.

Some annuity contracts offer a "step-up" death benefit guarantee. A basic annuity death benefit is equal to the greater of the premiums paid or the cash value at death. In a stepped-up death benefit, the cash value is "captured" periodically for purposes of the death benefit guarantee; that captured cash value amount becomes the floor of the death benefit until cash value is again stepped up. Let's look at an example:

> **Example.** Suppose Nick has paid total premiums equal to $100,000 for his variable annuity and the contract's accumulated cash value is $150,000 on the contract anniversary at which the step-up occurs. Assuming no withdrawals are taken, Nick's death benefit, because of the step-up guarantee, will never be less than $150,000—the cash value on the anniversary on which the step-up occurred. In the following year, Nick's contract's cash value falls to $120,000. If he dies at that time his death benefit will still be $150,000, even though the cash value is $30,000 less than that. However, if he replaces his variable annuity for another variable annuity, the death benefit under the replacement contract will only be $120,000. He would have lost the previous guarantee and $30,000 in death benefits.

The potential loss of guarantees under an existing variable annuity's guaranteed living benefits provisions is similar. If the existing contract contains a Guaranteed Minimum Accumulation Benefit, for example, the contract owner is guaranteed a return of their premiums at the end of a 10-year period, despite poor separate account performance. If the contract is replaced before the end of that guarantee period, the guarantee is lost.

> **Example.** Suppose Felicia had paid premiums of $100,000 into her variable annuity contract containing a GMAB rider. At the end of 7 years, because of dismal separate account performance, her annuity's cash value is $50,000. Angry and disappointed, she replaces her variable annuity contract with another variable annuity and moves the $50,000 of cash value to the new contract. If she had waited until the end of the 10-year period, the GMAB guarantee would have returned her $100,000. By replacing the contract, she lost that guarantee along with $50,000.

In addition to guarantees provided in the contract, it is also possible to lose tax benefits in an exchange. As we briefly noted when we discussed taxes, contracts issued before August 14, 1982, carry tax benefits that could be lost in a replacement transaction. Annuities are long-term investments, so it's not out of the question that you would encounter one of these, but a replacement of a contract that is over 30 years old will be a definite rarity. If you encounter one, seek professional tax advice, as with any tax issue.

*Knowledge Check*

Carla is considering recommending her client replace his existing deferred variable annuity for a newer deferred variable annuity contract. What must she show in order for the exchange to be suitable?

A. That the new contracts guaranteed gain will be greater **[Your answer is incorrect. Replacement of a deferred variable annuity-whether or not done through the mechanism of a Section1035 exchange-must result in a demonstrable net benefit to the client. If a registered representative cannot demonstrate that such a client benefit would result, it is unsuitable.]**

B. That the replacement results in a net benefit to the client **[Your answer is correct. Replacement of a deferred variable annuity-whether or not done through the mechanism of a Section1035 exchange-must result in a demonstrable net benefit to the client. If a registered representative cannot demonstrate that such a client benefit would result, it is unsuitable.]**

C. That the current deferred variable annuity is beyond the surrender charge period **[Your answer is incorrect. Replacement of a deferred variable annuity-whether or not done through the mechanism of a Section1035 exchange-must result in a demonstrable net benefit to the client. If a registered representative cannot demonstrate that such a client benefit would result, it is unsuitable.]**

D. That enhanced benefits are available under a newer contract **[Your answer is incorrect. Replacement of a deferred variable annuity-whether or not done through the mechanism of a Section1035 exchange-must result in a demonstrable net benefit to the client. If a registered representative cannot demonstrate that such a client benefit would result, it is unsuitable.]**

### 8.3.3 Replacements that Make Sense

Despite issues with surrender charges or the possible loss of guarantees or grandfathered benefits in certain exchanges, some exchanges may be suitable and make good sense for the client. Although there certainly may be other suitable reasons for exchanging one annuity for another, exchange of an existing annuity for the following reasons is often appropriate:

- **To change to a different type of annuity**—a client who owns a declared-rate fixed annuity may want to participate in the potential gains possible under a variable annuity. If the exchange is otherwise suitable, the client's exchange of the fixed annuity for a variable annuity could be appropriate;
- **To obtain newer benefits**—insurers regularly introduce new benefits that may be available only under their newer variable annuities, such as the guaranteed living benefits and enhanced death benefits described earlier. A client might find such new benefits attractive. If the exchange of the earlier annuity contract is otherwise suitable, such an exchange could be appropriate;
- **To obtain enhanced investment options**—early variable annuities limited the variable subaccounts to which a contract owner could allocate premiums to far fewer than the investment options offered under newer contracts. Often, a contract owner had only three subaccount options: a stock fund, a bond fund, and a money market fund. Under modern variable annuities, a contract owner may find they have 20, 50, or more variable subaccounts to which premiums may be allocated. If the exchange is otherwise appropriate, a contract owner's desire to have additional investment options may help make such an exchange appropriate; and
- **To use cash value management tools**—modern variable annuities offer contract owners the opportunity to manage the volatility of annuity cash value through various tools that were not available under earlier variable annuities, such as automatic asset re-balancing, dollar cost averaging subaccount transfers, and interest sweep.

Often, however, many of the changes that clients are looking for may already be present if they own a variable annuity, or may be added by rider.

Before we move on, remember that the suitability analysis is only part of the equation. The benefits of the replacement must serve the best interest of the client and no one else.

*Knowledge Check*

Which of the following individuals do NOT have a good reason for exchanging their annuity?

A. Roberto has reached the end of the surrender charge period. **[Your answer is correct. Exchanging an annuity that has reached the end of its surrender charge period for an annuity with new surrender charges, reduces liquidity and should not be done without some reason that overrides that loss.]**
B. Ben wants to get access to new investment options. **[Your answer is incorrect. Exchanging an annuity that has reached the end of its surrender charge period for an annuity with new surrender charges, reduces liquidity and should not be done without some reason that overrides that loss. Getting access to new investment options is a possible reason.]**
C. Chad is looking for long-term care benefits that his current annuity does not provide. **[Your answer is incorrect. Exchanging an annuity that has reached the end of its surrender charge period for an annuity with new surrender charges, reduces liquidity and should not be done without some reason that overrides that loss. Getting long-term care benefits is a possible reason.]**
D. Teresa's annuity has been performing poorly. **[Your answer is incorrect. Exchanging an annuity that has reached the end of its surrender charge period for an annuity with new surrender charges, reduces liquidity and should not be done without some reason that overrides that loss. Eliminating poor performance is a possible reason.]**

## 8.4 Replacement of Life Insurance

In the course of selling life insurance, you are likely to encounter a situation in which your client already has life insurance but you believe that you can provide a policy that is superior to the current policy. This leads, potentially, to a replacement transaction.

Replacements often yield little benefit to clients and result in big commissions to the agent—which is generally what drives the abusive forms of these transactions. Clients can lose on these transactions by—

- Paying big surrender charges on the old policy;
- Becoming subject to new and longer surrender periods on the new policy;
- Paying higher premiums on the new policy due to a higher issue age; and
- Becoming subject to issues of suitability and rating on the new policy.

All riders and guarantees may also be affected. All this is very similar to what we saw with annuities.

Not all replacements are abusive, however. Your client may have bought a policy 20 years ago that is quite inadequate to their current needs. You may decide that you can use the value in the policy to update your client's coverage to better meet the current needs. There is nothing wrong with that. In fact, you could be doing the client a great service in making the recommendation. But the state has rules regarding the suitability of replacements and the documentation of replacement transactions that we have discussed and you must know and follow.

### 8.4.1 Tax Consequences of a Replacement

As with annuities, surrendering a life insurance contract can trigger taxation of all the gain that is in the contract. The tax law contains a provision we have already discussed, however, that allows for a tax-free exchange of life insurance policies (a "section 1035 exchange").[17]

To qualify for tax-free treatment—

- The transaction must be an exchange. Receiving cash and making a purchase doesn't work; and
- The owner and the insured of the replacement policy must be the same as the owner and insured of the exchanged policy.

If you are considering a replacement, you should get advice on whether your client can take advantage of this provision.

#### *Knowledge Check*

All of the following are examples of adverse results of a replacement transaction EXCEPT

A. Sanford replaced a whole life policy with a variable universal life policy. **[Your answer is correct. Sanford's replacing of a whole life policy with a VUL policy is not (necessarily) adverse.]**

[17] A life insurance policy may also be exchanged for an endowment or annuity contract. Endowment contracts may be exchanged for endowment contracts and annuities may be exchanged for annuities, but neither may be exchanged for a life insurance policy.

B. Cecil paid a surrender charge of 6% on the substantial cash value of the old policy. **[Your answer is incorrect. Sanford's replacing of a whole life policy with a VUL policy is not (necessarily) adverse. Cecil's having to pay a surrender charge is adverse.]**
C. Raquel was out of the surrender charge period on the old policy but the new policy has an 8-year surrender charge period. **[Your answer is incorrect. Sanford's replacing of a whole life policy with a VUL policy is not (necessarily) adverse. Raquel's having to start a new surrender charge period is adverse.]**
D. Ivan's premiums on the new policy were rated due to his high blood pressure, which was not true of the old policy. **[Your answer is incorrect. Sanford's replacing of a whole life policy with a VUL policy is not (necessarily) adverse. Ivan's having to pay rated premiums is adverse.]**

## 9.0 Special Rules for Senior Clients

Under Regulation 187, insurers are required to have procedures designed to prevent financial exploitation and abuse. The regulation defines "financial exploitation and abuse as:[18]

> . . . improper use of an adult's funds, property or resources by another individual, including fraud, false pretenses, embezzlement, conspiracy, forgery, falsifying records, coerced property transfers or denial of access to assets.

The concern about a client's best interest is compounded with senior clients, particularly those who are beginning to show signs of diminished capacity. In this section, we will talk briefly about how to recognize diminished capacity, how to recognize when your client is being defrauded by other, and your responsibilities in working with senior clients.

As noted above, the insurer is responsible for maintaining procedures. You will be expected to follow them.

Now, let's start with recognizing diminished capacity and what to do if you see it.

### 9.1 Recognizing Diminished Capacity

Loss of ability can be a gradual process or it may occur suddenly as the result of a stroke or sudden illness. Some of the signs are obvious even in strangers and some are subtle and difficult to see unless you've known the person for a long time.

The signs of diminished capacity can be sorted into the following categories:

- **Cognitive incapacity.** This can include things like short-term memory loss, trouble staying on topic, difficulty in finding words, or difficulty with calculation. This last one suggests, however, the importance of knowing how the client functioned at their best—many people never have an easy time with calculation. People with cognitive incapacity can get lost or not know the time or what day it is. People with cognitive incapacity often know it and try to hide it, so one sign of cognitive incapacity could be deferring to others. Your client might say, "oh, my wife always

[18] 11 NYCRR 224.6(f).

takes care of that" when it might not be true. We've all heard about seniors who become rigid and set in their ways, but this could be a cognitive difficulty in understanding multiple or alternative viewpoints—or it could be a life-long way of thinking.

- **Emotional incapacity.** This manifests itself in extremes and changeableness. Your client could be experiencing distress that is beyond what is normal for the situation—extreme anxiety, worry, crying, depression, and so on. Changeableness is also a warning sign. A person who goes from laughter to tears in a second could be having a problem. Keep in mind, though, that emotional incapacity can be totally separate from financial capacity. A client may be acting strange on an emotional level and still make shrewd and appropriate financial decisions.
- **Behavioral incapacity.** All of this overlaps with your client's general ability to function. It may not matter for financial purposes if the client is having difficulty shopping or cooking, but problems managing money is obviously a concern. Difficulty communicating by phone could also be a problem, or just a sign of hearing loss. It is important to pay attention if a senior client complains that neighbors are stealing from them. Complaints like these could be delusional but, as we will see later in this section, financial abuse of seniors is all too common.
- **Relationships with others.** We've already considered the situation where an individual hides their incapacity by deferring to others. People who are fully capable may still be fearful about financial transaction and may depend on others. This is their right and may serve them well. The concern is about overdependence, fear, and isolation. Is the relationship one of trust? Is it a long-term relationship? Or has you client found a new friend in a long-lost family member, caregiver, or acquaintance?
- **Mitigating factors.** We want to stress that we are talking about warning signs here. They can alert you to diminished financial capacity, but they can also often be explained by stress, fatigue, medical problems, hearing or vision problems, or simple personal differences. The important thing is to know the clients complete situation or to consult with friends or family if things appear to be wrong.

### *Knowledge Check*

Which of the following individuals is most likely to have cognitive incapacity?

A. Douglas met you briefly at a concert and doesn't recognize your name when you call to set up an appointment. **[Your answer is incorrect. Although memory loss is part of diminished cognitive ability, not remembering your name after a brief meeting at a concert is something we all do. Layla's trouble staying on topic could be a sign of diminished cognitive ability.]**
B. Esther doesn't know what a variable annuity is. **[Your answer is incorrect. Although difficulty finding words can be part of diminished cognitive ability, not knowing what a variable annuity is, is common. You're looking for persistent difficulty with words, not just one word. Layla's trouble staying on topic could be a sign of diminished cognitive ability.]**
C. Layla never finishes a sentence and jumps from topic to topic. **[Your answer is correct. Layla's trouble staying on topic could be a sign of diminished cognitive ability.]**
D. Anthony responds to a question about his taxes by suggesting you call his accountant. **[Your answer is incorrect. Although deferring to others can be a sign of diminished cognitive ability, it is not uncommon for people to refer you to their accountant for information about their taxes. Layla's trouble staying on topic could be a sign of diminished cognitive ability.]**

## 9.2 Anticipating and Responding to Diminished Capacity

Consider this fact: When a client starts to experience real diminished capacity, there are only three possibilities: There are really only three possibilities: (1) the client handles things on their own (despite the diminished capacity); (2) no one does it; and (3) someone else does it on their behalf.

In this section we're going to talk about the last option and the issues that flow from getting involved.

**Privacy Issues—Getting Family and Friends Involved**

A common response to declines in client abilities is to get family or friends involved. Before you rush out and call the kids, however, it is important to know the requirements of privacy laws that may apply to you. The rules basically say "keep it to yourself."

Your firm is required to have a privacy policy detailing how client information may be used. It's going to be pretty restrictive about sharing information outside the firm, and that probably means: no sharing with "the kids" without permission. This can get troublesome if a client starts showing signs of diminished capacity.

One way around this is to get clients to name someone in advance to be an emergency or trusted contact.

**Does the Client Even Have Legal Capacity?**

When a client enters into a contract, they must have legal capacity to do so. For adult clients, this is not normally an issue. Not much is required. But when a client starts to suffer diminished capacity, problems could arise. That is why firms want measures in place before a decline in capacity occurs. Transactions by seniors could be challenged by family members or heirs, after the senior client dies.

A client's capacity to transact business, of course, is not all-or-nothing. It depends on what they need to do. The legal capacity to make a will or designate beneficiaries is quite different from being able to understand and agree to an insurance or other financial transaction. To name a beneficiary in a will, for example, an individual need not know much more than who they want their property to go to and a general idea of what property they have. On the other hand, evaluating an investment like a variable annuity needs much more specific knowledge and ability.

**Advance Planning Tools**

What are some of the things you can do in advance to avoid problems after a client experiences a decline? Here are some possibilities:

- **Joint accounts.** Your clients may already have joint accounts, especially if they are married. Joint accounts can solve part of the problem of incapacity. If one joint tenant (Robert) becomes incapacitated, the other joint tenant (his wife Ashley) can still make decisions and authorize transactions in the account. This, of course, is limited to assets within the joint account.
- **Durable powers-of-attorney.** A power-of-attorney (sometimes referred to as a POA) is a document that gives one person (called the "agent" or "attorney-in-fact") the power to act on behalf of another (called the "principal"). A durable power-of-attorney is a similar document

that is durable. That is, it remains in effect even if the principal becomes incapacitated. It becomes void once the principal dies. These are commonly used for health care decisions and for financial decisions.

- **Trusts.** A trust is a third device that allows one person to manage property for another. It is generally the most complicated of the three tools we are discussing here. The main feature of a trust that concerns us here is that a trustee is given power to make financial decisions for the beneficiary of the trust (who could be your senior client—people may set up trusts naming themselves as beneficiaries). A trust can establish rules for exercising the power and may specify contingent beneficiaries for when the first beneficiary dies.
- **Guardianship.** A fourth tool for handling the financial assets of an incapacitated client is a guardianship. This section has been about advance planning tools. A guardianship is *not* an advance planning tool. A guardianship is a way to get a court to name a person (the guardian) to act for an individual after they have become incapacitated. It is costly and inflexible, so it is usually better to plan ahead.

With all of these, it is important to make sure that the person acting for your client is absolutely trustworthy.

## 9.3 Fraud and Elder Financial Abuse

One problem with having family, a friend, an agent, an emergency contact, or a trustee act for a senior with diminished capacity is that the person acting in a position of trust may not be so trustworthy. Fraud and elder financial abuse, sadly, is not uncommon. It is, therefore, important for you to understand and recognize this type of fraud. It's part of the Regulation 187 requirement, among other things. Fraud can come from trusted individuals, but it often comes from outsiders as well.

Women are nearly twice as likely to be victims as men.[19] This is largely due to the fact that women tend to live longer than men and often survive their husbands. The typical victim of elder financial abuse is in her 80s. Older adults are likely targets of scammers because that's where the money is. This does not mean that targets are well-to-do, however. It simply means that individuals who have saved money toward retirement all their lives are likely to have more than when they were young and first starting out.

Financially abused elders often lose independence as a result of their losses. They may lose their homes. They may be unable to provide for their own care and become dependent on family or government programs. They lose trust in others and become angry or suffer fear, guilt, shame, and self-doubt.

### 9.3.1 Who Are the Abusers?

Not all abusers are cynical criminals.

We are not forgiving anybody here. We just want to make you aware that abusers may appear as sympathetic characters. Often they are family members. For example:

- A child who helps the parent out and feels deserving of some help;

[19] The MetLife Study of Elder Financial Abuse: Crimes of Occasion, Desperation, and Predation against America's Elders. New York: Metropolitan Life Insurance Company, 2011.

- A child who is having financial trouble, possibly due to job loss, divorce, health problems, etc.; or
- Children who believe they can prevent the depletion of an estate due to the parent's illness.

There are many reasons, bad but understandable, and worse.

Of course, many abusers are not family members, but many are still people known and trusted by the elder. Here are some examples:

- Caretakers and personal care attendants,
- Neighbors and friends,
- Attorneys and financial services professionals,
- Pastors, or
- Doctors and nurses.

These are people we expect to be the best help and support in our retirement years. We are not asking you to be suspicious of everyone, but just to be aware.

### 9.3.2 Commons Schemes

In this section, we will talk about some common schemes that result in financial loss by elders. There is no way we can cover everything, but here are some examples:

- **Scams by strangers.** These are confidence schemes, home-repair cons, lottery and sweepstakes scam (send us $X and we'll send you your winnings), phishing (on the internet or otherwise) to get the elder to reveal account passwords or similar information.
- **Financial services abuse.** This can include outright fraud, high fees, and unsuitable sales. Annuities may be sold to people too old to ever collect and they could be financed (to give one example) through reverse mortgages, depleting the equity in people's homes.
- **Abuse by family and friends.** Earlier in this section we talked about tools that you can use to enable family and friends to help with financial decisions when your elder client's financial ability is in decline: joint accounts, powers-of-attorney, etc. But these tools can also be used by an unscrupulous family member to steal from the elder. Family members can also steal credit cards and checks or take the elder's money from an ATM. Sometimes they threaten harm or abandonment to manipulate the elder to give them money.

Do you see the problem? It is often difficult to distinguish between a true friend and an abuser. But there are some red flags you can look for.

#### *Knowledge Check*

All of the following are common reasons that younger family members might legitimately look to your senior client for funds EXCEPT

A. Your client's son Ira lost his job and needs money to support his family until he gets a new job. **[Your answer is incorrect. All these situations could cause problems for your client, but you should be suspicious of Hal's get-rich-quick scheme. Helping out a child like Ira who lost his job is common.]**

B. Your client's son Hal has a get-rich-quick scheme and wants your client to invest. **[Your answer is correct. All these situations could cause problems for your client, but you should be suspicious of Hal's get-rich-quick scheme.]**

C. Your client's son Steve had a medical emergency and now his home is in foreclosure and he needs help. **[Your answer is incorrect. All these situations could cause problems for your client, but you should be suspicious of Hal's get-rich-quick scheme. Helping out a child like Steve who had a medical emergency is common.]**

D. Your client's daughters Bianca and Gale want to set up a trust that would provide money for your client to live but protect the assets in case of a prolonged illness. **[Your answer is incorrect. All these situations could cause problems for your client, but you should be suspicious of Hal's get-rich-quick scheme. Working with children to protect an estate for inheritance is common.]**

### 9.3.3 Red Flags of Elder Abuse

Let's now consider some warning signs ("red flags") of elder financial abuse. A red flag is an alert. It is possible that you will see a red flag, but discover that no harm is being done when you investigate. But these are areas where experience has shown that abuse is common. There are a lot of red flags, so we will consider them in groups, starting with the elder's living arrangements.

**Living Arrangements**

The following are a number of red flags relating to the elder client's living arrangements. There may be cause for concern if the elder client:

- Has unpaid bills, eviction notices, or disconnected utilities despite adequate income;
- Has been subjected to property liens or has received foreclosure notices;
- Reports belongings or property that is missing;
- Is receiving care that is inappropriate to the size of the estate (could be too little or too much);
- Is giving away money or spending wildly; or
- Is making purchases that the elder would not have made, such as high-end electronics by a person who could never operate them.

**Relationships**

Now let's consider the warnings that may come from considering the elder client's relationships. The following factors may be cause for concern:

- The elder has a new "best friend";
- Isolation from family and old friends;
- Assets are transferred to the new friend;
- The elder's caregiver expresses excessive interest in the amount of money being spent on the elder;
- The caregiver seems to be "living off" the elder;
- Oversight of finances is surrendered to others without explanation or consent;
- The elder's spouse, partner, or friend runs up bills and finagles the elder into buying things;

- A family member or friend makes the elder feel guilty about their own job loss, foreclosure, or divorce;
- Signs of intimidation or reluctance to talk in front of family or caregiver; or
- Previously uninvolved relatives suddenly appear claiming rights.

**Accounts**

The red flags we've talked about up until now may come to your attention from discussions with your clients and their families. Here we are going to talk about some red flags that may come to your attention directly because of accounts you manage or are aware of. Here they are:

- Inclusion of new name on signature cards;
- Unexplained change of address;
- Bank or other account statements no longer go to elder's home;
- Unexplained withdrawals or transfers or confusion about them;
- Lack of concern about risks, commissions, or transaction costs;
- Unusual activity, including large, unexplained withdrawals, frequent transfers between accounts, or frequent ATM withdrawals;
- Checks written to "Cash";
- Transfers to suspicious characters or foreign countries where the client has no connection;
- Large credit card transactions or sudden increase in credit card debt; or
- Financial activity that would have been impossible for the elder (too complex or physically impossible, such as ATM transactions by someone who is bedridden).

**Documents**

Sometimes problems may be flagged in documents. Here are some that you should be aware of:

- Legal documents, including powers-of-attorney (POAs), that the elder did not understand when signed;
- Suspicious signatures on checks or other documents;
- Lack of documentation about financial arrangements; or
- Unexplained or unauthorized changes to wills or other estate documents.

**The Elder Client**

You cannot assume that your client is incapable. They may be fully capable and aware when they suffer financial exploitation. Listen to them. They may complain about stolen or misplaced credit cards, checkbooks, or retirement checks. Or they may have some confusion about these things. Are their concerns valid? Do they understand the transactions and arrangements that they are involved in? Are their explanations valid, or do they indicate confusion—or embarrassment?

Your client's life situation is a big factor. Changes in their ability to physically take care of themselves often signals increased financial vulnerability as well. Listen if your clients express discomfort with their caregivers. Another major factor you should pay attention to are circumstances that may make your client financially responsible for an adult child or other relative.

Special concern is required after the death of a spouse or other relative. And a major red flag occurs if an elder client suddenly becomes uncommunicative or, often worse, unavailable to talk.

### 9.3.4 If Financial Abuse Has Occurred

If you suspect financial abuse, it is important to get your facts straight. Remember that your client is likely to be embarrassed or unwilling to acknowledge that they've been victimized. You should try to get a full picture of the situation, but be gentle and nonjudgmental in your questioning. Once you have your facts together, there are steps that can be taken to hopefully stop a scheme before it is successful (or prevent future exploitation). Three important steps that can be taken are:

- Close joint accounts, if the threat comes from the joint holder of the account.
- Revoke powers-of-attorney, if the threat comes from the person authorized by the POA to act for the elder client.
- Get a responsible and trustworthy person involved to manage the funds.
- Get a lawyer involved.
- Call police or relevant regulators to report the abuse.

**Increased Transparency**

Regardless of whether a problem has arisen yet or you are planning for the future, it is important to consider getting multiple people involved. As we discussed in the chapter on diminished capacity, there are privacy issues to consider in doing this. You should know your firm's privacy policy. But generally, consents can be put into place in advance to allow people other than your client to be informed about the account. This could include:

- Family and/or trusted friends;
- Professional advisers, accountants, or lawyers; and
- Representatives from social service agencies that exist for this purpose (if your client doesn't want family or friends to be informed).

In addition, your supervisor and compliance department should be in the loop.

#### *Knowledge Check*

All of the following clients are exhibiting red flags of elder financial abuse EXCEPT

A. Harper has a new "best friend." **[Your answer is incorrect. Suddenly discovering a new "best friend" is a red flag. Giving a limited power-of-attorney to a child while recovering from surgery is not a red flag.]**
B. Jack's account has unusual, large, unexplained withdrawals. **[Your answer is incorrect. Making unusual, large, unexplained withdrawals is a red flag. Giving a limited power-of-attorney to a child while recovering from surgery is not a red flag.]**
C. Francisco recently changes his will to include an individual not known to the family. **[Your answer is incorrect. Making unexplained changes to wills or other estate documents is a red flag. Giving a limited power-of-attorney to a child while recovering from surgery is not a red flag.]**

D. Selena recently signed a power-of-attorney naming her daughter Lindsey until she recovers from surgery. **[Your answer is correct. Giving a limited power-of-attorney to a child while recovering from surgery is not a red flag.]**

## 9.4 Legal Protections When You Take Steps to Protect a Client

We have talked about various privacy and other protections for clients that apply during normal times. We have also talked about steps you can take in advance of any problem to authorize you to get help when things go wrong. Advance authorizations are a good idea and your firm will have policies about when and how to get these.

But there are times when authorizations are either not in place or may not cover a specific situation. In recent years, various laws have been adopted or are being considered to help you help your clients in these situations.

### 9.4.1 Immunity from Suit for Disclosure of Senior Financial Exploitation: Senior$afe Act

The federal Senior$afe Act enacted in 2018[20] provides immunity from lawsuit if you report suspected exploitation of a senior citizen under the following conditions:

- You made the report in good faith and with reasonable care; and
- You received training on exploitation of seniors from your firm (this course may be part of that training, but you may also receive firm-specific training).

**Who you can report to.** This law covers reports to a wide variety of agencies, including:

- State financial regulatory agencies (including securities or law enforcement authorities and an insurance regulators of any state, the District of Columbia, or any U.S. territory or possession);
- A variety of federal financial institution regulators (Comptroller of the Currency, FDIC, Federal Reserve System, Consumer Financial Protection Bureau, National Credit Union Administration, and State Liaison Committee);
- Financial Industry Regulatory Authority (FINRA);
- Securities and Exchange Commission (SEC);
- A law enforcement agency; and
- A state or local agency responsible for administering adult protective service laws.

While this list is broad, it is restricted to governmental agencies. Private and nonprofit organizations are not covered.

**To which proceedings immunity applies.** If you are in compliance with the requirements of this law, immunity applies to any civil or administrative proceeding against you both at the federal and state levels.

[20] Sec. 303 of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018.

Immunity does not prevent any legal action for any act, omission, or fraud that you may be guilty of. It just protects you from liability for making a report. You can't immunize your bad actions by reporting yourself!

**Who gets the immunity.** The immunity granted by this federal statute applies to:

- Insurance producers, registered representatives, and investment adviser representatives who are affiliated with a covered financial or associated with a covered financial institution;
- Individuals who serve as supervisors or in a compliance or legal function (including Bank Secrecy Act officers) for a covered financial institution; and
- The financial institution (credit union, depository institution, investment adviser, broker-dealer, insurance company, insurance agency, or transfer agent)

In the case of the individuals listed, immunity applies if the individual took the required training. In the case of the financial institutions, immunity applies if they gave the training (or otherwise made sure their people got the training).

**Required training.** If you are taking this course, chances are good that you are getting the required training, but talk to your compliance department for sure. Here is what the law requires:

- **Content.** The training must discuss how you identify and report suspected exploitation of a senior citizen both internally and, as appropriate, to government officials; discuss the need to protect the privacy and respect the integrity of each individual customer; and be appropriate for your job responsibilities.
- **Timing.** You must receive the training as soon as reasonably practicable and, if you are a new hire, within 1 year of your date of employment, affiliation, or association.
- **Records.** Your firm must maintain records of this training for each individual (including training completed before employment, affiliation, or association or before the enactment of this federal legislation). These records, together with the content of the training, must be made available to the relevant regulatory agencies.

**Firm Policies and Procedures**

This is a difficult area. While the Senior$afe Act may give you immunity if you report suspicions to the various legal and protective agencies listed above, it doesn't give much guidance for determining when such a report would be appropriate. Your firm will have policies and procedures that you will have to follow. Always consult with your compliance officer before taking any action.

### 9.4.2 Placing Holds on Suspicious Disbursements: FINRA Rule 2165

Blowing the whistle on scam artists without repercussions is only one of the changes to the legal landscape adopted in recent years. It's not enough to cry foul after the fact. Sometimes you want to stop the scam in progress. FINRA Rule 2165 gives you tools to do just that.[21]

[21] Keep in mind that FINRA rules apply to people and firms who are registered with the Financial Industry Regulatory Authority. That could be you if you have any type of securities license.

If you reasonably believe that your client is being financially exploited, you may act to prevent that by placing a temporary hold on any disbursement of funds or securities from their account. This will give you and your firm a chance to investigate the situation and either release the funds or securities or take further steps to protect the client. This is a powerful tool, but you must be aware of the details. Your firm will have procedures to help you with this type of situation, so you must always consult with your firm before taking action.

**Which clients are protected?** This rule applies to any client who is 65 or older and to any client who is 18 or older if you reasonably believe they have a mental or physical impairment that makes them unable to protect their own interest. This does not require a diagnosis by a professional. You may base this "reasonable belief" on your own observations.

**What constitutes financial exploitation?** The rule defines "financial exploitation" pretty much in the same way we have done in this course, but it's worth looking at how FINRA puts it. For the purposes of this rule, financial exploitation means:

- Wrongful or unauthorized taking, withholding, appropriation, or use of your client's funds or securities;
- Use of a power of attorney, guardianship, or other authority (such as a trusteeship) to gain control or steal (FINRA says "convert") your clients money, assets, or property. This may involve overt acts by the scammer or omissions to act and may or may not involve deception, intimidation, or undue influence.

**How long is the hold?** The hold is temporary. It's to give you a chance to do an investigation and take other steps, if necessary. You have 15 business days—unless the hold is terminated or extended by a regulator, agency, or court. You and your firm also have a procedure to extend the hold for up to 10 business days. We'll talk about that in a bit. But we have other matters to discuss first.

**Who needs to know about the hold?** You have 2 business days to give notice to:

- Everyone authorized to transact business on the account (this would include the client, joint accountholders, and others with power to transact business in the account); and
- Anyone designated as a Trusted Contact Person (see next section for more details on this).

Notice is NOT required to anyone who is suspected of being the exploiter, even if they are one of the people who would ordinarily be required to receive notice. You don't have to tip off the bad guy to what you are doing. Again, it is important to follow company procedures in these matters, so consult your compliance officer before taking action.

**What kind of investigation is required?** You were suspicious, you placed a hold on your client's disbursement, you notified everyone. Finally, you have to act on your suspicion. The rule requires you and your firm to conduct an internal review of the facts and circumstances that set this chain of events in motion. You are required to follow through. Is your client being financial exploited or was it a false alarm? The situation must be investigated to find an answer to that question.

**Need more time?** If you need more time for the investigation and your internal review is supporting your suspicion that financial exploitation of your client has occurred, is occurring, or will occur, you and your firm can extend the temporary hold by another 10 business days. A temporary hold may also be extended by a state regulator, agency, or court. This does not require a formal order, but the firm would need to maintain a record of an agency's request.

**A Firm's Written Supervisory Procedures**

There is more to this process than we have covered here. The rule requires your firm to maintain written supervisory procedures that cover the identification, escalation, and reporting of matters relating to the financial exploitation of the clients covered by the rule. You should become familiar with these procedures. They will also tell you who in the firm is authorized to place, terminate, or extend the temporary hold for the firm. This person (or persons) is required to be a supervisor or a compliance or legal officer for the firm.

**Recordkeeping**

As with so much in this business, recordkeeping is important and required by the rule. This includes records of:

- The request for disbursement that resulted in the temporary hold;
- A statement of your reasonable belief that financial exploitation of your client had occurred, is occurring, has been attempted, or will be attempted in the future;
- The name and title of the person who authorized the temporary hold;
- The notifications that went out; and
- The internal review of the facts and circumstances that was conducted as a result of the placement of the temporary hold.

**Temporary Hold Applies Only to Disbursements**

FINRA rule 2165 applies only to disbursements from the account. Securities transactions that don't result in disbursements are not covered. If you have concerns about transactions that do not involve disbursements, subject to your firm's procedures, you may have to report the problem to the authorities (previous section of this course) or to your client's trusted contact (next section of this course).

### 9.4.3 Trusted Contact Information: FINRA Rule 4512

We've talked in this course about the value of getting your client's family or friends involved when things start going wrong. This applies not just to financial exploitation. A trusted person can be a big help in cases of diminished capacity. We've also talked about obstacles to getting this type of assistance that come out of privacy laws. We've talked about how getting the client to authorize a trusted contact in advance is a good way around this problem.

FINRA Rule 4512 formalizes this advice for member firms.[22]

[22] FINRA Rule 4512(a)(1)(F) and Supplementary Material .06 on the identification of a trusted contact as part of the Customer Account Information rule.

**How is trusted contact information collected?** Firms are required to make reasonable efforts to obtain the name and contact information for a trusted individual who may be contacted in connection with the account. This occurs at the time an account is opened and periodically when account information is updated. At these times, the client receives a written notice describing the types of information that may be disclosed to the trusted contact. A client is not required to provide a trusted contact. The firm is just required to ask. If a customer declines or simply fails to respond, the firm cans still open and maintain the account.

**Who may serve as the trusted contact?** Anyone the client designates may be a trusted contact, provided they are at least 18 years old.[23] The trusted contact must be a person, however, and not a business entity. The rule does not prevent joint accountholders, trustees, individuals with powers of attorney, etc. from being designated as trusted contact. The only requirement is that they are individuals who are at least 18 years of age.

**What may be disclosed to the trusted contact?** FINRA Rule 4512 allows the following to be disclosed to the trusted contact:

- Information about a customer's account to address possible financial exploitation;
- Contact information for the client (has there been a change?);
- Health status (is the client's capacity to manage their account impaired?);
- Identity of any legal guardian, executor, trustee or holder of a power of attorney; and
- Any notice of temporary holds placed on disbursements under Rule 2165 discussed above (again, not if the trusted contact is suspected of financial exploitation).

Keep in mind that these disclosures pertain to people designated as "trusted contacts" under the rule. Individuals may have other relationships to your client that may entitle them to broader access to information, such as joint accountholders, people with powers of attorney, trustees, guardians, etc.

Your firm will have policies and procedures governing the naming of trusted contacts and any disclosures that might be made to them. Always consult your compliance officer before disclosing any information to a trusted contact.

## 10.0 Producers and Insurers

Any of the requirements of the best interest standard that we have discussed in this course that apply to producers will apply to you whether you had direct contact with the client or not. The question will be whether you materially participated in making the recommendation and whether you received compensation as a result of the sales transaction.

Product wholesaling, product support based on generic client information, or providing education or marketing material does not constitute participation in making the recommendation.[24]

**Insurer's Suitability Determination**

[23] FINRA does not require you or your firm to verify the age.

[24] 11 NYCRR § 224.4(k), 11 NYCRR § 224.5(d).

The obligation to the client does not end when you submit an application to an insurer. The insurer is required to deny the sale unless there is a reasonable basis to believe that the transaction is suitable based on the suitability information provided by the client.[25] As we noted earlier in this course, you are prohibited from interfering with an insurer's efforts to verify information with the client.

**Complaints**

Clients who become unhappy with your services or the services of the insurer have a right to file a complaint with the Department of Financial Services. You are prohibited from dissuading (or attempting to dissuade) the client from doing so or from cooperating with the investigation of the complaint.[26]

**Financial Planning Credentials**

The reason you are taking this course is (probably) that you are a licensed insurance producer. You may or may not have other credentials.

Under Reg 187, merely being a licensed producer does not automatically qualify you to provide financial planning services. Although you may tell your client that a sales recommendation is part of a financial plan, you are prohibited from saying (or implying) that your recommendation is:

- comprehensive financial planning;
- comprehensive financial advice;
- investment management; or
- related services

unless you have a specific certification or professional designation in the area. You may not use the designation of "financial planner, "financial advisor," or similar title unless you are properly licensed or certified to do so and you actually provide securities or other non-insurance financial services.[27]

**Insurer Supervision**

Insurers are required to establish and maintain a system of supervision designed to achieve compliance with the standards we have been discussing in this course, including standards and procedures for the:

- collection of the client's suitability information;
- documentation and disclosure of the basis of any recommendation; and
- the review of complaints received by the insurer regarding recommendations that may be inconsistent with the best interest of the client.

In reviewing recommendations, an insurer may use a reasonable risk-based approach to target recommendations that have the highest risk of violation. But all types of recommendations must be part of the review process, not just high-risk recommendations.

The insurer may hire a third-party to establish and run its system of supervision.

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[25] 11 NYCRR § 224.6(a). This determination is made without regard to the availability of products or services from companies other than the insurer. This also does not apply to a sales transaction that results from the exercise of a contract right in a policy.
[26] 11 NYCRR § 224.4(i).
[27] 11 NYCRR § 224.4(j), 11 NYCRR § 224.5(c).

**Compensation Systems**

We've discussed the question of compensation in this course a number of times. The issue under Reg 187 is whether you might be influenced by your compensation to make a recommendation that is not in the client's best interest. This is not your obligation alone. Insurers are required by the regulation to design their system of compensation and incentives that avoid recommendations by producers that are not in the best interest of the client. Differences in compensation based solely on the amount of premium paid are not violations.[28]

**Compensation Systems 2**

Insurers may offer different versions of a product, one with a fee-based structure and one with a commission-based structure. When this is available, the insurer is required, under the regulation, to provide the client with a comparison showing the differences between the products.[29]

**Training**

Insurers are responsible for making sure that you are trained to make recommendations in the best interest of the clients. This course may or may not be part of your insurer's program. But it is not possible for a single course to meet this requirement. A course like this discusses the standard and procedures you should follow, but part of any suitability determination is understanding the costs and benefits of the products that you review and recommend. That portion of your education is ongoing and outside the scope of this one course.

**Violations**

Violations of Regulation 187 are considered unfair methods of competition or unfair or deceptive acts or practices in the conduct of the business of insurance in the state of New York and subject to appropriate penalties for such violations. Insurers are required to take appropriate corrective action for any client harmed by a violation of Regulation 187. In determining penalties in the case of the insurer, corrective action may be considered on the positive side, but any pattern or practice on the part of the insurer may be considered on the negative side.[30]

## 11.0 Summary

This concludes our course on New York Regulation 187: Suitability and Best Interest of Clients in Life Insurance and Annuity Transactions. While the formulation of the regulation may have been new to you, we hope you discovered that many of the concepts are familiar. If you have been in this business for any length of time, you have been doing most of the things that the regulation requires all along. If not, it is time to step up your game.

[28] 11 NYCRR § 224.6(d)(1) and (2).
[29] 11 NYCRR § 224.6(h).
[30] 11 NYCRR § 224.6(j) and § 224.8.

In this course, we discussed the source of Reg 187 in the fiduciary duties of care and loyalty and how meeting these duties is related to your determination that a proposed sales transaction is suitable for your client.

We discussed the types of policies—life insurance and annuity—that are governed by the regulation and the differences in how you are required to handle new sales transactions and in-force transaction for which new sales compensation does not apply.

We covered the types of information you are required to collect in your client fact-finding in order to make a proper suitability analysis.

We discussed the details of what the regulation means by a best-interest recommendation including the requirement that your personal interest in the sale not be in conflict with the client's, the requirement that you properly inform your client about your recommendation, and the requirement that the recommendation be suitable for the client. We expanded on the suitability discussion with illustrations of how the requirement applies to both annuities and to life insurance.

We discussed special rules that apply to term life insurance because that product lacks an investment component and to in-force transactions that lack new sales compensation.

We explored the special rules that apply to replacement transactions both under Reg 187 and Reg 60.

We discussed your obligations to senior clients, to recognized and cope with diminished capacity, and to recognized and respond to elder financial exploitation, including a discussion of the federal Senior$afe Act (immunity from suit when you report financial abuse), FINRA Rule 2165 (placing holds on suspicious disbursements) and FINRA Rule 4512 (regarding the collection of trusted contact information).

And finally, we discussed the insurer's responsibility for supervising your compliance with all these requirements.

We hope you learned some valuable lesson that will serve you well in your business.

**Thank you for studying with RegEd!**