

Insights: Alerts

Iowa Proposes State-Specific Best Interest Rules for Insurance and Securities Businesses

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UPDATE: On April 29, 2021, the Appellate Division of the New York State Supreme Court, Third Department, issued a decision that struck down New York's rule for a best interest standard in annuity sales (Department of Financial Services' Regulation 187, Suitability and Best Interests in Life Insurance and Annuity Transactions) for being unconstitutionally vague.

UPDATE: As of December 30, 2020, Arizona, Arkansas, Michigan, and Rhode Island have joined Iowa in adopting the NAIC model rule for best interest standard in annuity sales. Alabama, Delaware, Kentucky, Maine, Nevada and Ohio were also considering legislation or regulations that would implement the model rule. New York has its own rule (that is different than the model rule).

UPDATE: May 11, 2020, Iowa [adopted its proposed regulation](#) requiring annuity agents to act in the best interest of consumers, but delayed adoption (or revision, withdrawal) of the companion securities rules. The Commissioner said that he expects to return to the securities proposals later this summer.

Notwithstanding the stay on the BD-specific rules, our Alert below includes discussion of how changes in the State's insurance rules could nonetheless impact state, SEC and FINRA supervision and recordkeeping obligations for broker-dealers and investment advisers with representatives who are also insurance agents in the State.

Iowa has proposed a "best interest" rule (not a fiduciary rule) governing the sale of insurance products and the offer and sale of securities by broker-dealers ("BDs") and their registered representatives ("RRs"). The rules, if enacted, will apply to producers, BDs, and RRs with offices in the State or who are providing services to consumers/customers living in the State.¹ Below are some questions and answers aimed at helping financial professionals and BDs understand the potential implications of the proposed rules.

- 1. Several states have proposed or adopted fiduciary rules for BDs. What's different about the Iowa rulemaking proposal?**

On February 27, the Iowa Insurance Division (the “Insurance Division”) – led by Insurance Commissioner Doug Ommen, who also serves as the state’s top securities regulator and the current president of the National Association of Insurance Commissioners (“NAIC”) – filed a proposed rule to apply a “best interest” standard to insurance agents and RRs in the sale of insurance products, and securities, respectively.

The provisions included within the proposed rule track the NAIC’s Suitability in Annuity Transactions model rule, which was drafted with a goal of harmonizing annuity sales with standards governing the sale of securities under the SEC’s Regulation Best Interest (“Reg BI”) (set to become effective June 30, 2020).

In its proposed rule, Iowa also proposed amendments to Chapter 50, Regulation of Securities Offerings and Those Who Engage in the Securities Business. The amendments add in several new sections that codify a best interest standard that includes a duty of care and a disclosure obligation, making it similar but not identical to Reg BI.

This proposed rule is one to watch because insurance commissioners in other states and jurisdictions are likely also considering adoption of the NAIC model rule.

Insurance rules are enforceable against insurers and their producers, not BDs or investment advisers (“IAs”). However, the insurance rules, as proposed, require producers to create records and obtain information from consumers, that, once created/obtained, would alter the recordkeeping and supervisory obligations of a BD or IA with which that producer is also registered, if the consumer is also a customer/client of the BD or IA.

2. What is the comment deadline? When will the new rule become effective?

The comment period on the rulemaking is currently scheduled to end April 28, 2020.

The proposed rule contemplates an effective date of January 1, 2021.

3. What are the new requirements for the sale of insurance products – including annuities² – in Iowa?

A “producer” is defined as any person or entity required to be licensed by the Insurance Division to sell, solicit, or negotiate insurance, and includes an insurer where no human producer is involved.³ Under the proposed rules, when making a recommendation to a consumer of an annuity, a producer must act in the best interest of the consumer under the circumstances at the time of the recommendation.⁴

The producer’s best interest obligation includes a duty of care, disclosure and documentation.⁵ Fulfillment of these obligations is assessed based upon the circumstances at the time the recommendation or sale is made (*i.e.*, the obligation is not ongoing, but the producer also, presumably, cannot rely on information obtained from the consumer in the past).

The *Duty of Care* requires that the producer: (1) have a reasonable basis to believe the recommended product would effectively address the consumer’s financial situation over the life of the product;⁶ (2) have a reasonable basis to conclude that the consumer would benefit from the features of the specific annuity recommended; and (3) communicate the basis of the recommendation to the consumer prior to or at the time of the sale.⁷ In making these assessments, the producer is required only to consider the types of products the producer is authorized

and licensed to recommend or sell, and is held to standards applicable to producers with similar authority and licensure.⁸

The obligations to have a reasonable basis for the recommendation and to communicate that basis to the consumer create new recordkeeping requirements for producers (and the insurers with which they are licensed). The proposal also includes additional requirements, including recordkeeping requirements, applicable to exchanges or replacements of an annuity.⁹

The *Duty of Disclosure* requires producers disclose on a template form provided by the State (or something substantially similar):

- (1) a description of the scope and terms of the relationship with the consumer and the role of the producer in the transaction (*i.e.*, something similar to the Form CRS required under Reg BI);
- (2) an affirmative statement as to whether the producer is licensed to sell the following products: fixed annuities, fixed index annuities, variable annuities, life insurance, mutual funds, stocks and bonds, and certificates of deposits;¹⁰
- (3) how many insurers the producer is licensed to sell annuities on behalf of;¹¹
- (4) a description of the sources and types of cash and non-cash compensation that the producer will receive relative to the recommendation; and
- (5) an affirmative notice that the consumer has the right to request additional information about compensation.¹²

As to the source of compensation, the disclosure must explain “whether the producer is to be compensated for the sale of a recommended annuity by commission as part of premium or other remuneration received from the insurer, intermediary or other producer or by fee as a result of a contract for advice or consulting services.”¹³

If the consumer requests additional information about the cash compensation, the producer must disclose:

- (1) a reasonable estimate of the amount of cash compensation that the producer will receive, which may be stated as a range of amounts or percentages; and
- (2) whether the cash compensation is a one-time or recurring amount, and if recurring, the frequency and amount of each occurrence.¹⁴

The *Duty of Documentation* includes making a written record of the recommendation and the basis for the recommendation, as well as getting signed client consent where a client declines to provide the requisite consumer profile information (as defined in the proposed rule) or where a client requests a transaction that was not recommended by the producer.¹⁵ The proposed rule includes template forms that can be used to meet these requirements.

The proposed rule substantially enhances the requirements for an insurer's supervision system, including requiring myriad new written supervisory procedures (“WSPs”) that operate to require producers to create additional documentation regarding: (1) a consumer's investment needs and objectives at the time of the recommendation or sale, and (2) communications between the producer and the consumer. For example, the

proposed rule contemplates WSPs that require confirmation of the consumer's profile information at the time of sale, producer and consumer interviews, producer statements and attestations, and processes for identifying and addressing "suspicious consumer refusals to provide consumer profile information" (i.e., where the producer or someone working on behalf of the producer may have committed fraud).

For producers who are also RRs, these requirements will likely result in producers generating records that, once created, will become required records that the BD must retain. Specifically, the records will become subject to FINRA and SEC rules requiring that a BD retain all communications relating to its business as such (when the producer is selling a variable annuity)¹⁶, customer investment profile, and suitability information (when the consumer is also a BD customer, regardless of the product sold to the consumer).¹⁷

BDs are only required to confirm the accuracy of customer account information (used for making suitability determinations) every 36 months. However, if a BD customer's RR is made aware of a change to a customer's investment profile through the producer's insurance business, then that knowledge is likely to be imputed to the BD relative to its supervision of any securities recommendations made to that customer after that knowledge is obtained.¹⁸

The proposed rule also includes additional provisions regarding when insurers contract with third-parties to provide supervision, and additional requirements for producer training/continuing education.

4. Is there anything in the insurance rules that create different or heightened rules for producers who work for BDs or IAs?

Not directly, but the insurance rules do state that the conduct standards applied to producers are those of similarly licensed producers, implying that RRs and IARs may be held to heightened standards under the insurance rules.¹⁹

Producers are licensed with the State through insurers. Those same individuals may also be RRs or IARs. The BD or IA has an obligation to supervise the producer's insurance activity as an outside business activity, and when the activity involves the sale of variable annuities, which are considered a security by the SEC, FINRA and many states, the BD or IA has expansive supervisory obligations relative to that activity.

BDs may also have selling agreements and/or other arrangements with insurers such that a BD receives a portion of the commission or other remuneration associated with the sale of insurance products to the BD's customers and/or in which the BD agrees to assume some of the insurer's recordkeeping or supervisory obligations relative to the activity of the producer/RR. Nothing in the current or proposed rules suggests that these agreements subject the BD to the jurisdiction of the Insurance Division's enforcement of the State's insurance regulations.

The proposed insurance rules contain a safe harbor for producers and insurers (subject to certain limitations) who recommend or sell annuities²⁰ in compliance with "comparable standards." The proposed rule goes on to explain that comparable standards for BDs are FINRA rules, Reg BI, and the State's proposed best interest rule, and for IAs are the fiduciary duties outlined under the Advisers Act of 1940 (for federally-registered IAs), or the Iowa Advisers Act (for state-registered IAs).²¹ (The existing rule contains a safe harbor for producers who act in compliance with FINRA rules.)

5. What is required of BDs under the proposed best interest rule?

Under the proposed “best interest” revisions to the State's Securities Act, when a BD or its RR recommends the purchase, sale or exchange of securities or an investment strategy involving securities (including account recommendations), the BD or RR must have a reasonable basis to believe that the recommendation: (1) is in the best interest of the customer; and (2) does not place the financial or other interests of the RR or BD ahead of the customer's interest.²²

The *Duty of Care* requires that, in making a recommendation, the RR exercises reasonable diligence, care, and skill to: (1) know and understand the retail investor's investment profile²³; (2) know and understand the potential risks, rewards, and costs associated with the recommendation; (3) have a reasonable basis to believe that the recommendation effectively addresses the retail investor's investment profile; (4) have a reasonable basis to believe that a series of recommendations in the aggregate is not excessive and effectively addresses the retail investor's investment profile; and (5) have a reasonable basis to believe that prior to or at the time of the recommendation, the retail investor has been reasonably informed of the basis of the recommendation, including its risks, rewards, and costs.²⁴

The *Duty of Disclosure* requires that, prior to or at the time of the recommendation, the RR provides the retail investor full and fair disclosure of: (1) all material facts relating to the relationship between the customer and the RR, including that the RR is acting as a RR of a BD, the material fees and costs that apply to the transactions, holdings, and accounts, and the type and scope of services provided to the retail investor including any material limitations; and (2) all material facts relating to the conflicts of interest that are associated with the recommendation.²⁵

The *Duty to Identify, Eliminate, Mitigate and Disclose Conflicts of Interest* requires that BDs and RRs: (1) identify and eliminate, or at a minimum disclose, all conflicts of interest associated with recommendations of any securities transaction or investment strategy involving securities to a retail investor; (2) mitigate any conflict of interest that creates an incentive to place their interest ahead of the retail investor's interest; (3) identify and disclose any material limitations on the securities or investment strategies that may be recommended to a retail investor and any conflicts of interest associated with such limitations and prevent such limitations from placing the RR or BD's interests ahead of the retail investor's; and (4) identify and eliminate any sales contests, quotes, bonuses, and non-cash compensation that are based on the sales of specific securities or types of securities within a limited period of time. In order to remain in compliance, BDs must establish, maintain, and enforce policies and procedures reasonably designed to achieve compliance.²⁶

As proposed, a violation of the State's best interest rule would be deemed an act, practice or course of business which operates or would operate as a fraud or deceit, and a manipulative, deceptive or other fraudulent scheme, or device, and as such, a final order by the State finding such a violation could subject a RR or BD to collateral consequences with other state and federal regulators, including statutory disqualification under various provisions of federal securities laws.

6. How does the Iowa proposed best interest rule for BDs differ from Reg BI?

The rule proposal states that it is intended to be consistent with Reg BI. There are a handful of instances, however, in which the proposal departs from Reg BI. These mostly appear to have been inadvertent. For

example, Iowa uses the term “retail investor” instead of “retail customer” and omits “and uses the recommendation” from what is otherwise the same definition in Reg BI.

One notable, substantive difference between the Iowa proposal and Reg BI is that the Iowa rule includes within its Duty of Care an obligation that the BD/RR “have a reasonable basis to believe that prior to or at the time of the recommendation the retail investor has been reasonably informed of the basis of the recommendation and the potential risks, rewards, and costs associated with the recommendation.”²⁷ As drafted, this arguably creates an additional recordkeeping obligation as well as a supervisory obligation beyond what is required under Reg BI. (The proposed insurance rule has an identical requirement, one that cannot be superseded through application of “comparable rules” under the safe harbor.)

Another notable distinction of the Iowa rule, as compared to Reg BI, is the collateral consequences that would follow an order finding a violation of the Iowa rule that result from a violation of the rule being considered a manipulative, deceptive or other fraudulent scheme, or device.

7. Do any of the proposed revisions seem likely to be removed or changed in the rulemaking process?

We do not have any special insight into what the State is likely to revise following public comment. We expect that additional steps necessary to bring the proposed rule into alignment with Reg BI are likely. Moreover, we hope that the Insurance Division (and indeed the NAIC) will consider revising its safe harbor provision to avoid confusing, duplicative, or overlapping regulatory regimes relative to BDs and IAs with RRs who are also insurance producers.

8. Anything else interesting in the rulemaking explanation?

Under *Purpose and Summary*, the State explains that the rule making “will preserve consumer choice so that many more middle-class Iowans will retain access to retirement education and security that they choose. The detailed regulatory framework promotes informing consumers about risks, benefits and costs of any recommended transaction. This standard requires the financial professional to always put the consumer's interest first and to only make recommendations that match the particular Iowan's needs, objectives and situations. This proposal is consistent with the efforts of the SEC and will be very beneficial to consumers.”

Under *Fiscal Impact*, the State adds: “Purchasers of annuities and securities investors should benefit from the proposed rulemaking due to enhanced standards of care placed on licensed industry professionals. It is not possible to quantify the impact in any given transaction, but overall the expectation is that purchasers/investors will end up with products that better fit their needs.” (Emphasis added.)

It is interesting that the State has explicitly stated that product selection is at the heart of its rulemaking; whereas other state rulemakings have hinted at concern regarding specific products, like variable annuities, but have primarily focused their discussion on bringing greater clarity to the applicable obligations owed by the financial professional when the same person is providing services relative to a brokerage account, an investment advisory account, and/or insurance contracts.

If you have any questions about the Iowa rule proposal, Reg. BI, the regulation of BDs, RRs, or state- or federally-registered investment advisers, please feel to contact us.

Footnotes

¹A note about nomenclature: Under the insurance rules, a **producer** is a person or entity in the business of selling insurance products (on behalf of insurers), and the **consumer** is the term used to describe the person buying the product. Under securities laws: A **broker** or **RR** is the term generally used to describe a person offering to buy or sell securities (on behalf of a BD), and the **customer** is the person placing orders to buy or sell securities in their account. (RRs are also permitted to provide investment advice so long as it's incidental to the offer and sale of securities.) Producers and RRs are generally compensated through transaction-based compensation (*i.e.*, commissions). An **investment adviser representative** ("IAR") is a person who provides investment advice about buying or selling securities to **clients**, and they generally receive a fee for these services, which may be a flat fee or a percentage of assets under management.

In practice, a single person (financial professional) can (and often does) act as a producer, IAR and RR, relative to accounts held for the benefit of a single person who is a consumer (when buying insurance products), a customer (when placing trades to buy or sell securities in their brokerage account) and a client (when receiving investment advice pursuant to a financial planning or investment advisory agreement).

Herein, when discussing the potential collateral impact on a BD's ability to comply with its regulatory obligations (particularly, recordkeeping and supervision) under federal and state securities laws, we are speaking to situations in which a producer may be offering insurance products to a consumer who is also the BD's customer.

²As this Alert is directed primarily toward BDs with RRs who also sell insurance products, the answer to this question references annuities and insurance products interchangeably.

³Rule 191-15.74.

⁴Proposed Amended Rule 191-15.75(1).

⁵*Id.*

⁶This requirement extends beyond the annuity to the underlying subaccounts to which funds are allocated at the time of purchase or exchange of an annuity, and riders and similar product enhancements, if any. 191-15.75(1)a-(7).

⁷Proposed Amended Rule 191-15.75(1)a-(1)1 through 4.

⁸Proposed Amended Rule 191-15.75(1)a-(3).

⁹Proposed Amended Rule 191-15.75(1)(10)1 through 3.

¹⁰Based on the format contemplated in the template form, this disclosure requirement may put producers who are not also RRs at a competitive disadvantage, as it will be apparent to consumers that the producer can only make recommendations relative to insurance products, and cannot make recommendations relative to securities that may better serve the consumer's investment objectives.

¹¹This disclosure also may create competitive advantages for producers who are licensed with multiple insurers and therefore are able to offer consumers a broader range of options.

¹²Proposed Amended Rule 191-15.75(1)b.

¹³Proposed Amended Rule 191-15.75(1)b-4.

¹⁴Proposed Amended Rule 191-15.75(1)b-5(2).

¹⁵Proposed Amended Rule 191-15.75(1)d.

¹⁶See SEC Rule 17a-4(b)(4).

¹⁷See SEC Rule 17a-3(a)(17) and 17a-3(a)(35), FINRA Rules 2111 and 2330.

¹⁸Aside from the proposed rules, it is generally a best practice for BDs/IAs to train their RRs/IARs to update customer account/client information any time information obtained by the RR/IAR contradicts and should supersede information in the account/investor profile for that same customer/client. Information siloed in insurance business records or in a CRM system may subsequently be deemed to have been known to the BD/IA.

¹⁹Proposed Amended Rule 191-15.75(1)a-3.

²⁰Annuities are specifically carved out from the definition of securities. See Iowa Code §502.102(28)(b).

²¹Proposed Amended Rule 191-15.75(5)a. Other categories of “comparable rules,” such as ERISA, are also described in the Proposed Amended Rule.

²²Proposed Amended Rule 191-50.104(1)-(2).

²³Investment profile is a defined term under the proposed rule that includes age, other investments, financial situation, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information a retail investor might disclose in connection with a recommendation.

²⁴Proposed Amended Rule 191-50.104(3)a.

²⁵Proposed Amended Rule 191-50.104(3)b.

²⁶Proposed Amended Rule 191-50.104(2)c.

²⁷Proposed Amended Rule 191-50.104(3)a-(5).

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