Legal and Moral Issues
In the Insurance Industry
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This course will address the following topics:
- Compliance, Ethics and Professionalism
- Our Working Legal Framework
- Communication and the Sales Process
- Common Compliance Problems
- Ethics and Compliance in Practice

This course includes:
- Four Chapters and Conclusion
- 1 Online Final Exam
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Chapter 1: Compliance, Ethics, and Professionalism

Our industry is being besieged by matters of compliance. This is especially true in the areas of life insurance and securities.

Some may privately express the view that compliance is an impediment to doing business and doing it successfully.

But isn’t the question really: should short-term gains take priority over long-term client relationships? The financial services business as a whole appears to be moving towards the development of fee-based client relationships as it moves away from the traditional transactional platform. And even if one’s business is transactional in nature, isn’t the question still whether profitability and expedience should take precedence over client problem solving?

At first sight, it seems that career agents for the major companies are most affected by strict compliance regulations. They are required to secure their companies’ compliance approval of correspondence, advertising, and sales materials. Even the manner in which they verbally describe the products and services they provide must be compliant.

However, independent insurance agents and those not closely associated with a major insurer are untouched by compliance requirements. Rather, compliance enforcement and oversight may be more difficult, as those who supervise agents’ activities may be further removed in time and place from the sales process.

The intention of this course is to refocus you on compliant and ethical professional behavior. If you always concentrate on a client’s needs and place them above your own, compliance should not be an obstacle in your practice. Putting the client first seems a simple concept, but sometimes it is difficult to implement.
COMPLIANCE VS. ETHICS

Compliance refers to the minimum required standard of conduct. These are the particular rules of conduct which have been made into law, designed to promote the interests of all parties in a transaction.

Ethics refers to an optimal standard of conduct. You are ethical when you do the “right” thing, but you need to be compliant to stay out of court. Actually, this is not entirely true; in today’s litigious society, one can sue anyone, at any time and for any reason. Although filing a lawsuit is not the same as winning a lawsuit, litigation is often used as a threat to keep agents honest.

Although it is true that society cannot legislate morality, it is also true that society tries to do so and, in fact, does legislate the most important aspects of morality. The law is certainly far better defined than either morality or ethics. While we may each have different beliefs and values, laws apply to all of us in the same evenhanded way.

Compliance and ethics are undoubtedly related concepts, but they are not one and the same. The ethical person does the “right” thing, while the compliant person does the legal thing.

SCOPE OF COMPLIANCE

Sales practices
A sales tool is everything an agent uses to communicate with a client that is designed to create an interest in purchasing or maintaining a product.

Examples of sales tools include:
- stationery (letterhead, business cards);
- published ads;
- brochures;
- authored magazine articles;
- newsletters; and
- interviews.

All of these items may be subject to compliance rules and review.

Sales practices refer to the manner in which we use sales tools and sales aids to introduce a product and/or to close a sale. Sales practices include such
discrete steps as:

- fact-finding;
- illustration;
- presentation; and
- implementation.

**Client interaction**

*Client interaction* refers to the sales processes above and all “soft” sales procedures, which may fall outside these boundaries.

Just because a written form isn’t completed and signed doesn’t mean you will not have trouble as a result of your oral representations. Although allegations of wrongdoing may be more difficult to prove in such cases, the goal is not to be a defendant that wins – it is not to be a defendant at all.

An agent has duties to the client, which include full disclosure and providing suitable products.

Therefore, client interaction covers:

- suitability;
- hidden rebating;
- oral representations; and
- fiduciary duties, to name the most prominent issues.

**Insurance company interaction**

An agent also has duties to the insurance company, including to act only within the scope of authority granted by the company and not to misrepresent the quality of the client, among others. Fiduciary duties and representations are examples of ways in which agents are responsible to their companies.

**The Insurance Professional – A Modern Oxymoron?**

Over the past three or four decades, the image of the business has changed dramatically. We can recall television shows such as *Father Knows Best* and *Leave it to Beaver*. Note that the fathers on both of these shows were insurance agents. Both were surrounded by an aura of professionalism that was accorded to their occupation. In the 1950s and even into the 1960s, being an insurance agent was an honorable and even respected profession.
When did attitudes on insurance change so drastically? What is the reason for the increasing emphasis on compliance? Why isn’t the profession accorded the same degree of respect as it was 30 years ago? Two major reasons come to mind:

(1) The prior actions of agents, their managers, and trainers. Put simply, we’ve done it to ourselves.

For example, for many years in the life insurance business, agents were trained to engage in questionable practices that are now correctly being challenged. They sold “vanishing premiums.” They called life insurance “retirement plans,” concealing the true nature of the product. For many years, disclosure was not in the vocabulary of the insurance salesperson, and suitability was not always an issue addressed adequately. Fact-finding became a rare art.

Life insurance prospects frequently were told that premiums would vanish without also being told that:

- an abbreviation of the premium paying period wasn’t necessarily guaranteed;
- premiums never “vanish”, but rather they continue to be paid by the policy owner from the policy values; and
- even if premiums did “vanish”, they might reappear if non-guaranteed portions of the policy (mortality expenses, dividends, interest rates) failed to perform as illustrated.

Moreover, the illustrations used to close a sale were often extremely aggressive, assuming unreasonably high interest rates or variable rates of return. In the end, the illustrated returns could not be sustained consistently, resulting in poor policy performance. The purchasers did not get what they expected.

Now, the pendulum has swung back. Suitability is the key, and full disclosure in all presentations is the mandate.

(2) There is the issue of money. Aside from the past actions of sales people and those who trained them, compliance has become important as a direct result of litigation. Insurance companies have been sued, and billions have been paid out as a result. They are the “deep pockets” of a grievance, and under the law of agency (which we will study in some detail a little later), they may be largely responsible financially for the damages resulting from the improper actions of their agents. Therefore, if the insurance companies can control the agents’ sales behavior, perhaps they can minimize litigation losses in the future from agents’
It took many years to besmirch the reputation of the industry. It will take many more to restore the public’s trust. Corrective action needs to begin somewhere, and now is as good time as any.

**Definition of a professional**

A professional is generally acknowledged to have three attributes:

- specialized knowledge in her field of endeavor;
- a service-before-income philosophy; and
- a code of ethics.

Let’s take a look at these elements individually.

Specialized knowledge element that some credential has been obtained after reaching a certain level of knowledge, ability, or experience. Frequently, this “level” is defined by an exam and is difficult to specify. Maintenance of the professional designation universally requires the pursuit of continuing education on a regular and substantial basis. Professionals in every area know shortcuts to “filling the credits” for continuing education compliance purposes. However, true professionals do not merely seek to comply – they *want* to learn. They seek meaningful continuing education in amounts beyond those required to further their knowledge, increase their ability to help their clients, and become better at what they do.

Service-before-income philosophy simply means the client’s interests are paramount. That actions will be recommended only if they help a client progress toward stated goals. It is not good enough to sell a product to a client because it both generates revenue for the seller and “doesn’t hurt the client.” The true professional always puts the client first. After all, the client doesn’t care how much you know until he knows how much you care. The Pledge of the American College states that the professional shall make every effort to ascertain, understand and take into account the conditions surrounding the client in making recommendations, thereby mandating adequate fact-finding to provide client-centered advice.

Every profession has a code of ethics. The codes set forth, in greater or lesser detail, the mantra of client-first thinking. To most of us, issues such as conflicts of interest, self-dealing and maintaining client confidences are obvious components of professional behavior.
We all strive to be considered professionals in whatever it is that we do. However, the mantle of being considered a professional comes at the price of increased liability. A professional will be held to a higher standard than one who is not a professional when judging the appropriateness, suitability and accuracy of information communicated to a client.

**Is it worth it?**

The value of being considered a professional may vary from person to person. We consider, however, that many financial service practitioners:

- seek to secure “professional designations”;
- lie about having such designations; or
- explain that they don’t need to have them to be considered a professional.

The business is changing, regardless of whether we want it to, regardless of whether we embrace the change. Products are now a commodity, and product availability is everywhere: at the workplace, at banks, through the mail, through telemarketing, and on the Internet. Therefore, service, knowledge, and advice are all that is left for us to sell.

Succinctly, professionals say they will do it better. We in the business know that generally, professionals are able to do it better. Most importantly, consumers believe that professionals will do it better.

**Changing Public Perception**

In the end, it is necessary to change the public’s perception – not of the insurance business but of you, the advisor. Even though we, in the business, know that insurance is one of the most complex financial products available to the public, the public doesn’t know that. In fact, by offering insurance of nearly every type over the Internet, at banks, etc., insurance companies themselves are saying that their products are simple by virtue of the fact that they are simple to buy.

Therefore, like it or not, the business is changing, and many say we must change with it. In fact, some say we will also change substantially, voluntarily or involuntarily. We might find ourselves in the business of wholesaling an insurance commodity, in the business of selling advice, or even out of business altogether.
THE CONTROVERSY

The fee-based planner believes that the consumer perceives a basic conflict of interest with the commission compensation model, stating that even an “honest” commissioned salesperson is only human and will be tempted to sell to cater to his own needs rather than the client’s. Furthermore, the fee-based planner points out that no matter how good the commission-based planner may be, the latter is not compensated unless and until he sells something. Therefore, planning (the careful articulation of goals followed by the thoughtful designing of strategies to reach those goals) is not a primary concern – he cares first about the sale of a product.

The commission-based planner counters by pointing out that the commission model has worked well for many years. He adds that the consumer’s perception is not changing. Furthermore, he suggests that fee-based planning is a sham; it is only a veiled product sales scheme. Finally, the commission-based planner says that no matter how good a plan is, it is a failure if it is never implemented, and since many strategies work better with products attached, it is the product sale that makes the plan.

Let’s look at some of the basics involved from a compliance and ethics standpoint.

Who may call themselves a financial planner?

The financial planning designations include ChFC, CFP and CPA-PFS. However, as a practical matter, anyone can call themselves a financial planner. Such a title may be unethical to use if the individual is too narrowly focused (only sells insurance, only sell securities, only sells and provides no written plan). Donning the title of financial planner to step up one’s positioning in the marketplace also steps up one’s liability. Whether or not you have earned the title, if you hold yourself out to the public as a financial planner, you will be held to the same standard of conduct as a prudent financial planner.

Who may collect a fee for planning?

Generally, one may not receive compensation for providing advice about
securities or hold oneself out to the public as being in the business of doing so without being appropriately registered either as an Investment Advisor or as an Investment Advisor Representative working for, with, and under a Registered Investment Advisor. The filing and disclosure requirements, somewhat involved details, are beyond the scope of this text. However, it is important to realize that under the Investment Advisor Act of 1940 (the law requiring such registration), and the subsequent SEC Release IA-770, the law’s intent is to create a fiduciary relationship between the Registered Investment Advisor and the client. The exceptions to the registration requirement are relatively few and fraught with traps for the unwary.

Registering as an Investment Advisor and providing the required disclosures to clients does not allow the use of the letters RIA as a designation. In fact, it is not a designation. It does not indicate any level of education or expertise.

**What is financial planning?**

Financial planning is generally taken to mean a process consisting of the following steps:

- Establishing financial goals;
- Gathering relevant data
- Analyzing the data gathered;
- Developing strategies to achieve goals;
- Implementing the plan; and
- Monitoring and modifying as needed.

A majority of professionals in the financial services business believe that the business is changing. Insurance companies are changing their names to “financial services companies” to imply the availability of a broad base of services and to dispel the impression of being a mere warehouse of products. The Life Underwriters Association and the Society of CLU and ChFC changed their names to the National Association of Insurance and Financial Advisors and the Society of Financial Service Professionals, respectively, to attempt to separate them from being pigeonholed.

For the most part, the view is that consumers can get information anywhere – they need professional assistance in analyzing and applying it to their particular situations. The up-front planning approach appears to satisfy the client’s desire for advice, first and foremost. If a fee is charged, the fee-based planner believes he can spend more quality time on a client’s plan – as he or she is being paid to do so – than if no fee is charged. It is also widely believed that
most wealthy clients expect to pay a fee for advice, so the lack thereof may cause them to be suspicious. Finally, the fee-based planner believes that the existence and the amount of the fee positions him or her in the wider field of the business.

Although a majority of financial services professionals do not charge a fee for advice at this time, the number is growing. It is far less prevalent in the property and casualty side of the insurance industry, but it still exists.

There are no right and wrong responses in this debate, but it raises some important questions. Do fees promote the appearance of professionalism? Are they, in fact, a good positioning tool? Can they truly solidify relationships with clients and increase sales? Is fee-based planning the future for the insurance business? Consider these issues and decide whether ethics should play a role in the answers.
Chapter 2:
Our Working Legal Framework

Federal Influence

In dealing with insurance regulation, we think instinctively of the state departments of insurance – after all, they license us and deal with our trade practices. However, the federal government, whose influence is on the rise, has a very significant effect on the conduct of insurance companies.

The American insurance industry did not really take off until the mid-1800s, and at that time, not all insurers were adequately capitalized or competently managed. State agencies were created to supervise these insurance companies. Problems and conflicts arose as a result of individual states regulating business conducted across state lines. In the 1869 U.S. Supreme Court decision *Paul vs. Virginia*, insurance was declared not interstate commerce.

The insurance industry continued to grow with continued state-level regulation. In 1944’s *U.S. vs. Southeastern Underwriters Association*, the Supreme Court reversed 75 years of precedent and declared that insurance may be within the interstate commerce clause of the Constitution and hence within federal jurisdiction. This decision cast doubt on the states’ abilities to continue to regulate and tax the insurance industry.

McCarran-Ferguson Act

In response, Congress enacted the McCarran-Ferguson Act in 1945 to preserve state regulation of the insurance industry. In subsequent challenges, the Court made it clear that the law affords the states the ability to pre-empt federal antitrust law and leave to federal regulation only those areas left unregulated by the states. However, the federal government did retain jurisdiction over those matters deemed to be “national in character.” Meanwhile, federal influence on the insurance business has increased due to the importance of federal regulation in the following ancillary areas.
Statutory inroads: IRS
The power to tax is the power to destroy. Those who deal with life insurance issues know that much of their business is tax-driven. Significant changes in the estate and gift tax laws have significantly affected the business and will continue to do so in the future. Many fear that changes in the tax treatment of the inside build-up of cash in life insurance and annuities could have a catastrophic impact on their business. Without a doubt, the tax-advantaged cash build-up inside life insurance policies and the income tax-free payment of death benefits play a very important role in the placement of large amounts of life insurance.

Statutory inroads: ERISA
Those involved in the pension and retirement plan business know the significance of ERISA, (Employee Retirement Income Security Act) passed in 1974, and the subsequent federal tax legislation affecting employee retirement plans:

- 1981 Economic Tax Recovery Act (ERTA)
- 1982 Tax Equity and Fiscal Responsibility Act (TEFRA)
- 1984 Retirement Equity Act (REA)
- 1986 Tax Reform Act (TRA)
- 1987 Omnibus Budget Reconciliation Act (OBRA)
- 1989 Revenue Reconciliation Act
- 1990 Revenue Reconciliation Act
- 1992 Emergency Unemployment Act
- 1993 Omnibus Budget Reconciliation Act
- 1994 Retirement Protection Act (RPA)
- 1996 Small Business Job Opportunities Act
- 2001 Economic Growth and Tax Relief and Reconciliation Act of 2001 (EGTRRA)

Running afoul of these complex pieces of legislation can result in significant liability.

Statutory inroads: HIPAA
The 1997 Health Insurance Portability and Accountability Act affected many areas of the health insurance field.

Perhaps it is most noted for its “Granny goes to jail” legislation, which sought to make rendering oneself eligible for Medicaid illegal. Due to a public backlash, this law was quickly converted into the milder “lawyer goes to jail” legislation which outlawed the providing of otherwise legal advice given to aid a
client in becoming Medicaid eligible. A lawsuit by the New York State Bar Association resulted in the repeal of this legislation, as well.

HIPAA is also the legislation that created the tax-qualified Long Term Care Insurance policy.

**Statutory inroads: SEC**

The last major area of federal regulation involves securities legislation. Many of the insurance products we sell actually deal with two areas: insurance and investment. As a result, the SEC exerts considerable influence in both licensing and product registration.

**State Regulation**

If we think about our first contact with any kind of insurance regulation, it likely would be with the state insurance department, when we took our licensing exam. State insurance regulation includes the following agencies:

- **Legislature** – enacts and amends insurance law.
- **Regulator** – the state insurance commissioner and insurance department with broad administrative, quasi-judicial and quasi-legislative powers.
- **Courts** – adjudicating conflicts and defining the parameters of state authority.
- **NAIC** – an unincorporated voluntary association of the principal regulatory authorities of each state, designed to promote uniformity in insurance laws, disseminate information to regulators, protect policy owners, preserve state insurance regulation, and serve as a common forum for the development of model laws and regulations.

The state regulates with the following goals in mind:

1. To ensure reliability and solidity of the industry;
2. To ensure fairness and equity in the treatment of policy owners by insurance companies;
3. To continue state control over insurance; and
4. Economic and social goals to expand the availability and affordability of coverage.

**Licensing agents and product approval**

Although a corporation exists legally once it is officially incorporated, every state requires that an insurance company doing business in that state secure a
license or certificate of authority. Similarly, each state requires agents selling and/or consulting on insurance to secure a license to do so. Furthermore, the states reserve the power to permit and approve the sale of various products. Each state has its own criteria driving these decisions. This licensing and approval power is the foundation of regulatory control. Along with controlling the conduct of those who sell insurance, licensing raises revenue for the state.

**Market conduct issues**

Aside from technical regulation of companies, agents and products, the states regulate how products are represented, distributed, and sold to the public.

The NAIC’s *Unfair Trade Practices Act* prohibits:

- flagrant misrepresentation of dividends in illustrations and sales presentations;
- false advertising;
- defamation;
- using methods of intimidation;
- falsifying financial statements; and
- misrepresenting one’s own qualifications.

The state also controls *rebating*. Companies may not reduce a premium or give something valuable to a customer that is not specified in an insurance policy. This attempts to curb cutthroat competition, prevent discrimination among similarly situated policy owners, and discourage replacement.

**COMMON LAW**

Common law (as opposed to Roman law, modern civil law, and other systems) was originally developed and formulated in England. It is a body of rules and principals, written and unwritten, deriving from legislation, customs and judicial precedent which ultimately became general law in the English colonies, later augmented by subsequent legislation but kept largely intact after the Revolutionary War.

If insurance salespeople only needed to worry about federal and state regulations, the boundaries of errors and omissions would be straightforward and fairly simple. But official government regulations do not tell the whole story. Insurance companies are also liable for an agent’s violation of common law principles of agency.
The law of agency

Insurance companies act through its agents, meaning those persons acting on its behalf and subject to its control. The creation of the agency relationship imposes on the agent fiduciary duties, some of which may even outlast the agent-company relationship.

A servant-agent, typically an employee, is so classified because he or she is subject to a principal’s control both as to what is to be done as well as the agent’s physical activities. A non-servant-agent also acts on behalf of the principal but is not subject to the principal’s control of his or her physical activities. While a principal is usually not liable for injuries resulting from unauthorized physical conduct of a non-servant-agent, the principal usually is liable for the physical conduct of its servant-agents when it occurs within this scope of their employment, even if the agent’s actions are unauthorized.

A subagent is an agent of a non-servant-agent, and therefore also acts on the principal’s behalf. An example of a subagent is the registered representative of an incorporated stockbroker. Whenever a corporation is an agent, a subagent must act for it. The subagent owes a fiduciary duty to both the principal and the first agent. The principal, in most cases, would have good cause of action against both the first agent and the subagent for the latter’s otherwise improper performance of the agency.

Neither a contract nor consideration is required for there to be a valid agency relationship – only consent of the parties is necessary. A power of attorney is a non-contractual appointment of an agent. Sometimes, even the mere appointment to a position may create an agency.

Termination of the Relationship

Absent any contract with termination restrictions, an agency relationship may be terminated at will. When an agent terminates the agency by violating his contract, the principal may have a course of action against the agent for damages and may even be able to get a court order preventing the agent from forming a similar relationship with others.

The death or incapacitation of the principal nearly always terminates the relationship, even if the condition of the principal is unknown to the agent and third party. This can present some real problems in dealing with an individual’s agent, although the hazards are fewer with agents of corporations.
**Agent’s Authority**

It is the agent’s *actual authority* that binds the principal. Actual authority may be express or implied. *Express authority* is granted from the principal’s explicit statements – for example, an insurance agent’s contract, which details the agent’s authority. *Implied authority*, appropriately, is that that power which can be reasonably deduced from the principal’s statements but was never specifically voiced. For example, the insurance agent’s contract may give an agent the *express* authority to solicit sales of its insurance, but the authority to send solicitation letters or make telemarketing calls to arrange appointments is *implied* in the grant of authority to solicit business.

As long as an agent has actual authority, whether express or implied, her acts on behalf of the principal binds the principal. It doesn’t matter whether a third party dealing with the agent believes he has actual authority. Actual authority in the insurance business is becoming more and more finely delineated by contract. Generally, actual authority doesn’t pose much of a hazard to the insurance company, which goes out of its way to limit the agent’s authority. However, if a company knowingly or negligently allows its agents to engage in unethical sales practices, there might be a valid claim that they gave their agents implied authority to do so. In an attempt to limit implied authority, many companies require that sales practices, advertisements and even correspondence must receive compliance approval prior to being used.

Even if actual authority is missing, a principal may still be bound by an agent’s apparent authority. *Apparent authority* means that a third party would reasonably believe that a person still has actual authority. For example, a terminated agent who was allowed to keep company letterhead, business cards and marketing materials, might be able to bind the company or cause them damage should he or she solicit additional business from prior clients, collect premiums and fail to turn them over to the company.

**Principal’s ratification**

We have seen how apparent authority can validate contracts beyond an agent’s actual authority. Where an agent does not have authority, a principal’s *ratification* can make it as if actual authority existed at the time of the act or representation.

For a valid ratification,

- The principal, and not just the agent, must know the facts of the transaction;

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The principal must have validated the agent’s acts, possibly by an express statement, but frequently by acquiescence in the transaction; and

The agent must have originally presented himself as an agent for the principal and the third party reasonably believed this representation; and

The entire transaction must be ratified, as ratifying a portion is considered a counteroffer.

Ratification requires no additional considerations. The third party does not need to have been damaged or even to have changed position due to the agent’s act or representation. Even if the principal negates an agent’s act, subsequent ratification is not needed. Ratification does not have to be communicated to the agent or third party, as the principal’s conduct that is the key.

The purpose of taking an in-depth look at the common law concept of agency is to emphasize that the insurance companies we represent are liable for our actions. The current emphasis on compliance is the industry’s attempt to mitigate that liability by limiting and channeling our actual authority as agents.

**Other legal concepts**

Does a client who has been dealing with an insurance agent in a particular manner for a long period of time have a legal right to rely on the continuation of that manner of business? There is no clear answer.

Under common law, the concepts of course of dealing, course of performance and trade usage and custom were all lumped together. However, there are subtle differences.

*Course of dealing* has to do with conduct *prior* to an agreement between parties.

*Course of performance* relates to conduct *after* an agreement during which a relationship has been perpetuated without objection.

*Trade usage and custom* refers to regularly observed practices in a trade which justify an expectation that such will continue to be observed in the future.

Although generally heeded as common law, rules relating to course of dealing, course of performance and trade usage have been actually written as part of the Uniform Commercial Code.
Waivers
A waiver, another legal term, is the voluntary relinquishment of a known right. Often, when there is an alleged waiver of some condition after the formation of an agreement, some additional consideration is needed to make the waiver enforceable.

In the past, life insurance companies with very low policy loan rates frequently requested its policy owners waive their right to such rates in favor of a variable rate. This request was made at some point after the policy was placed in force. In return for that waiver, the company would offer payment of some kind, such as higher cash value crediting, etc.

Estoppel
Estoppel differs from a waiver in that a right is relinquished involuntarily.

Estoppel limits a person from denying the existence of a certain condition once that person has previously acted in a way that suggests that condition exists, even if the condition is false. A distinction in the law is made between two types of estoppel:

- **Equitable estoppel** (estoppel in pais) - One who presents something as an existing fact resulting in the justifiable and detrimental reliance of another is estopped from denying the representation.

  **Example**: Unknown to the bank (B) and to the property owner (O), O’s son forges O’s name to a mortgage loan. On discovering the loan, O makes payments to B. O is estopped from later claiming the mortgage is invalid, as B has detrimentally relied on O’s payment as an acceptance of validity.

- **Promissory estoppel** – When a promise is made, even without consideration, the one who makes the promise is then unable to deny the validity or enforceability of that promise.

  **Example**: A promise by an insurer to accept a late payment will prevent (estop) the insurer from rejecting such payment and lapsing the policy due to the late payment.

Election
After a decision has been made, one cannot later change his mind to the detriment of another. Election, therefore, affects both parties, not only the party electing, but also the party who is held to some performance as a result of the
choice made. An election may be made by formal representation, by conduct or by promise. An election made by promise generally requires some return consideration in order to be enforceable. Remember, consideration can include not only money or things of value, but also the forbearance from exercising what might otherwise be right.

An insured has an auto accident and makes a settlement with the company representing the “other guy” who caused the accident. As part of the settlement, the insured elects to have the repairs done at a repair shop recommended by the settling insurance company with full payment for repairs by that company and with a guarantee on those repairs. The insured is told that repairs will take four weeks. Two weeks into the repair period, the insured states that he would rather have the cash settlement. Obviously, at this point, the insured made an election. The insurer has begun to perform accordingly and would be hurt at this point if the insured could change his mind.

**Caveat vendor**

It is understandable that the above concepts may appear to be confusing. Often, they are complicated in practice, as well. In addition, the application of these concepts constantly changes with new fact patterns and new emphasis on ethics and compliance.

The law and its application is dynamic – it responds to changes in mores and societal demands. In the field of financial services, society has demanded more protection for its members and increased accountability from financial services companies. In response to these demands, laws and regulations have been written with detailed requirements regarding disclosure, record keeping and continuing education. Insurance companies and other financial services firms have added another layer of compliance to try to limit their agents’ actual authority, force appropriate disclosure, record-keeping and education, and hence insulate themselves from exposure to liability.

In dealing with the sales of goods, wares and merchandise, the general rule is *caveat emptor* – let the buyer beware. Although there are exceptions, mostly dealing with fraud and misrepresentation, the buyer has an affirmative obligation to investigate.

In the financial services field, the general rule is *caveat vendor* – let the seller beware. There is an affirmative obligation on the part of every insurance agent and registered representative to sell appropriate, suitable products allowing the client to make choices only after all relevant facts are known. Moreover, our files must contain evidence that we did so.
Following will be a brief discussion on industry self-regulation. The remainder of this text will be dedicated to reviewing specific sales guidelines with the aim of emphasizing disclosure and suitability.

**Food for Thought**

*Self-regulation in the insurance industry*

**IS THE WOLF IN CHARGE OF THE HENHOUSE?**

A 1990 survey of CLU’s and ChFC’s resulted in generation of a list of ten perceived ethical problems in the industry. A 1995 survey of MDRT members found the same 10 issues to be a problem.

- False or misleading representations of products or services;
- Failure to identify customer needs and make suitable recommendations;
- Lack of knowledge or skills;
- Conflict between personal gain and proper performance;
- Misrepresenting the limitations of one’s ability;
- Disparaging competitors, products, agents;
- Failure to be objective with others in business dealings;
- Failure to provide prompt, honest responses to client questions;
- Failure to provide the highest quality products and services; and
- Conflicts of interest in dealings with clients and suppliers that appear to influence the ability to carry out responsibilities.

**IMSA**

Insurance is based on trust. The above listed 10 items demonstrate the perception of a lack of trust.

In October, 1995, the ACLI (American Counsel of Life Insurers) drafted six principles of ethical conduct, and on November 15, 1995, IMSA began operation.

IMSA – the Insurance Marketplace Standards Association – is a voluntary association of life insurers who banded together to change the image of the business. Specifically, their purposes are three-fold:

- To assist members to design and implement sales and marketing practices that benefit and protect the consumer;
To provide an assessment process for continual review, monitoring and modification; and
To strengthen consumer confidence.

IMSA’s Ethical Market Conduct Program consists of six basic principles, a Code of Ethical Conduct, comments and an assessment questionnaire.

To become an IMSA member, an insurance company must participate in a rigorous self-assessment process that requires the completion of an assessment questionnaire. This questionnaire contains 27 main questions and many sub-questions. This is followed by an assessment by an outside, independent examiner, approved by IMSA, to verify that the company has met the standards required by the IMSA Code. Assuming the independent audit is satisfactory, membership is granted for three years.

Some potential problems with IMSA include:

- Fear that small and medium sized companies may not have the money to perform the internal and independent assessments and to audit their field staff.
- Fear that the assessment process may document a roadmap to litigation.
- IMSA may work well for large companies with career agents, but who will monitor the sales practices of the independents?

A 1998 Survey of CLUs and ChFCs reported all 10 ethical issues still being of significant concern, with four of the top issues the same in all surveys. Do you think that IMSA is effective? Should the IMSA model be spread to health insurers? to property and casualty insurers?

Moreover, there are many ways of enforcing ethical conduct. Read through the following list. Which ones are most effective? Which ones are most practical? Are there any other methods that you would like to see used?

- Civil and class action lawsuits
- Criminal action
- State Insurance Department action
- NASD action
- Profession self-policing
Salespeople should be in the habit of reviewing their sales materials every few months to ensure their propriety with regards to ethics and compliance. When examining your own stationery, documents, and illustrations, these are the most important features to consider:

1. Full and meaningful disclosure of all relevant facts to the client.
2. Presenting your products, services, and abilities in an accurate and honest manner so as not to result in any misrepresentations, including innocent ones.
3. Making sure the client has no illusions as to who you are, who you represent, and how you get paid.

What are sales materials and sales tools? Revisiting the definition used before, we will be talking about everything an agent uses that is designed to create an interest in purchasing a product or keeping the product sold.

This definition is very broad. Our intent in this discussion is to realize that information should be conveyed fully, fairly, honestly and without being misleading. Our definition purposely does not differentiate between intentional and unintentional misrepresentation. This industry is based on communication, and it is important to communicate effectively. At this juncture, a detour into the basics of communication is worthwhile.

Communication may be structured or unstructured. In financial sales and counseling, as an endpoint is sought, the communication is structured, and includes the following techniques.

- **Interviewing** – communication, usually between 2 people, with a specific purpose, usually the gathering of information. This includes


directive interviewing, where the interviewer controls both the pace and the content, and nondirective interviewing, which is less formal, with the interviewee having more control over pace and content.

- **Counseling** – giving help, in a less structured way than in interviewing. Here assistance is provided to clients as they explore their current situation and begin to understand where they are in relation to where they want to be.

- **Advising** – Offering a direct opinion on what a client should do. If offered too soon in the process, advice prevents the client from forming his or her own opinion, as the client defers to the “expert.”

As we engage our clients with communication through the stages outlined above, our goal is to establish a rapport with the client. Of importance in this quest is to take on a nonjudgmental attitude and to accept the client.

Resistance is frequently encountered as we attempt to communicate with our clients and assist them with their financial decisions. The resistance may be open hostility (anger, missing appointments, refusing to get down to business). The resistance may be more subtle when dealing with some sensitive topics such as death, family relationships, and the perception of one’s failure to attain desired goals. Resistance must be dealt with as early in the process as possible.

Frequently, we interpret resistance as an obstacle, objection, or rejection. Instinctively, this triggers a response in the successful salesperson. Here is where the communication difficulties arise. We must be careful to always send the correct message.

Most professionals in the financial services business are ethical and would not intentionally lie to achieve a sale. However, care must be taken to avoid unintentional misrepresentations. Effective communication occurs when the receiver of a message interprets the sender’s message in exactly the same way the sender intended it to be understood.

Communication failures may occur for a number of reasons.

- The sender may send mixed signals with body language or words with a double meaning.
- The receiver may be bombarded with a wide variety of outside stimuli during the course of the communication diluting his or her attention.
- Not all communication “noise” is auditory, as the receiver may have
his own built in stimuli – such as biases and prejudices – which can interfere with effective communication.

Without a doubt, the greatest single problem of communication is the assumption of its success. Financial services professionals, whose business is financial communication, are obligated to make that extra effort to ensure accurate communication has occurred in an unbiased manner where the free will and understanding of the client has not been usurped by the advisor.

With this in mind, let’s return to the examination of our sales tools and processes.

**Stationery and business cards**

The business card or letterhead is usually one of the first things a prospective client sees with our name on it.

These items create a first impression. Although there is wide artistic latitude in design, letterhead and business cards should identify who you are, who you work for, and what you sell. If you are a registered representative, it must show the name and address of your broker-dealer.

In many states and pursuant to the policies of many financial services firms, the title of financial planner may not be used without a ChFC, CFP or CPA-PFS designation and registration as an Investment Advisor or Investment Advisor Representative. Again, the goal is to not give a false impression.

It is a given that your company affiliation should be on your business card and letterhead. If your company has multiple associations, they must also be stated. If you go so far as to list on your card or letterhead specific products you sell and you represent multiple companies, you also need to identify the company with whom each product is placed and its principal home office.

A client or prospect, from your letterhead or business card, should be able to identify you as a property or casualty agent, a life insurance agent, a stockbroker, a registered representative, etc.

**Advertising and direct mail**

Advertising and direct mail present a special compliance challenge. Again, honesty, clarity, and brevity are the goals. The compliance concern is that the reader not be misled.

From a marketing standpoint, a piece must be written so as to catch the
audience’s attention and be readable, comprehensive and short. Therefore, the language used must take into account truthfulness and accuracy, but also the target audience’s level of understanding. Relating back to our earlier discussion of being compliant but unethical, when dealing with an unsophisticated audience, proffering too much truthful, detailed information could conceivably serve to deceive by obfuscating the bigger picture.

The immediate result sought from direct mail or an advertisement is the generation of interest leading to the scheduling of an appointment, at which time a sales presentation can be made. Therefore, the ad or direct mail piece needs to generate great interest in the product or service quickly, as the reader can lose interest just as fast.

Because an ad may need to spark interest even more quickly than a direct mail piece, the biggest compliance concern is a tendency to exaggerate product qualities.

Some examples of “exaggeration” follow. Though exaggeration was not intended in most cases, it is the result. These examples illustrate how important it is to choose words wisely to ensure accurate communication.

- **Description of a product or service as “revolutionary” or “new and unique.”**

  In all likelihood, the product or service described is not revolutionary, new, or unique. This type of description may be dismissed as “puffery,” or a “permitted” minor exaggeration that does not rise to the level of a misrepresentation. Such exaggeration is expected. However, in the financial services sphere, where a fiduciary relationship is said to exist, even minor misrepresentations are classified as deceptive and are not permitted.

- **Use of superlatives: best, lowest cost, safest, etc.**

  These should not be used unless the truthfulness of their representation can be verified to avoid the possibility of misleading a prospect.

- **Referring to certain products such as life insurance and annuities as tax-advantaged or tax-favored.**

  The tax advantages are obtained only after conforming to many rules.
Certainly an ad or a letter does not have enough space to detail how the tax advantages of a life insurance policy require it be a non-MEC (IRC §7702A), that IRC §101 dealing with transfer for value issues, and that the definition of life insurance be adhered to (IRC § 7702). Even if all of these explanations are made, if the prospect does not have a tax liability due to lack of taxable income, an excess of losses or any other cause, life insurance and/or annuities may not be tax-advantaged or tax-favored.

Finally, in any ad, letter, or other communication, aside from being truthful, it is always necessary to take into account the sophistication of your target audience.

**Personal brochures**

Personal brochures can be very effective sales aids. They are generally looked upon as an extension of a business card. They can highlight achievements, education, and memberships. Obviously, this information should be truthful without implying unrealistic expertise. Also, important information should not be omitted, such as the ability to offer securities and/or insurance and the affiliations that make such product sales possible.

Again, the guiding principle is that the brochure should allow the recipient to know who you are, what you do, what products you sell, what companies you represent, their addresses and telephone numbers, as well as your own address and telephone number.

**Magazine articles**

What’s the compliance problem with sending copies of magazine articles to your clients? Are there compliance problems with writing educational articles for magazines and journals?

The first question is easier to answer. First of all, without the consent of the author or publisher, there may be a copyright violation in distributing copies to clients. In addition, mere publication of an article is not a guarantee of accuracy and truthfulness of its content. Therefore, a compliance review would still be required prior to its use.

Writing articles for magazines and journals can be an excellent way to create or enhance a reputation as an authority in a particular area. As a practical matter, the ultimate purpose of such writing is to secure sales through the authorship of such articles. Therefore, such writing is considered the same as advertisements. The information presented must be factually correct and straightforward.
Many financial services firms maintain a library of prepared compliant articles on a wide variety of topics. They have already been screened for factual errors and possibly misleading communication. In most cases, the agent merely needs to add his or her name and it is ready for publication or mailing.

GUIDELINES OF THE SALES PROCESS

We’ve discussed some of the tools and materials used in the sales process, but we haven’t really touched on the sales process itself. How we use the sales tools is often more important to the prospect than the tool itself. In fact, many sales have been made without the use of any tools or sales aids, merely being the result of a well-executed sales process.

Noncompliance in the use of sales materials and tools can be obvious as the tools are tangible items available for inspection at any time. It is more difficult to prove noncompliance in the sales process area as it may not be accompanied by writing or tangible evidence of misrepresentation, though indirect and circumstantial evidence can be enough to win a lawsuit.

What is the sales process? Generally, it consists of the client approach, the fact-finding interview, the presentation of product solutions, and implementation. Our focus in examining these steps will be on the representations we make and the descriptions we use during our meetings and telephone conversations with clients and prospects.

Approach

The approach is the sales process-equivalent of the business card. It dominates a first impression, which can profoundly affect how the relationship proceeds, and ultimately, the ability to make a sale.

People generally do business with professionals and agents that they like, trust, and respect. The agent must be viewed as competent and credible before a prospect will even share financial information. Therefore, part of the approach is the need for the agent to accurately present his credentials and experience.

Obviously, there are several compliance concerns:

- First, there is the concern that the agent, in fulfilling his or her need to appear competent and experienced, will overstate his credentials, experience, or skills.
Second, because the agent needs to convey competence, experience, and trustworthiness in a very short period of time, exaggerations may be made in order to keep the process moving forward.

Third, the fact that an approach is relatively short in duration usually means that it is not the optimal forum to go into detail about any particular product or strategy. Therefore, there is the concern that during the approach, the agent may hype the benefits of tax-advantaged insurance products without full disclosure to the prospect.

Fourth, in an effort to simplify concepts to a prospect or to conceal information to avoid a reaction due to a bias, products may not be identified by their common name. The concern here is one of deception or misleading a prospect in referring to a life insurance policy as a retirement plan, a program, or a strategy, rather than what it is – a life insurance policy.

Fifth, there is an ethics concern about providing required disclosures and prospectuses to clients and prospects without reviewing the disclosures together, knowing that the client or prospect is not likely to read the information or is unable to do so due to a language problem.

Finally, the use of jargon may result in ineffective communication and may be misleading, even if the information conveyed is absolutely accurate.

The most serious problem at this stage is the agent’s misrepresentation of his or her skills, experience, credentials, or education by express statement or implication. An agent should not refer to himself or herself as a financial planner or financial advisor if he is only an insurance salesperson.

It is important to remember from our prior discussions that an agent’s misrepresentation of credentials, skills or education will result in that agent incurring the same liability as one who actually has the credentials, skills and education represented. The agent will be held to a high standard of care, and the client will have every right to expect the same service and advice given by the truly skilled professional.

The opening interview
This is the opening interview, the first substantive meeting in the sales
process. The purposes of this meeting include:

- Furthering and nurturing the relationship;
- Disturbing the prospect;
- Gathering facts and data to allow the fashioning of a presentation.

Here again, the most prominent ethical issue is ensuring that full disclosure takes place. The client must be apprised that the agent is an advocate for particular product or particular company. Representing a particular insurer or broker-dealer without disclosure to the client raises the specter of concealment and potential deception. Just because we are not discussing letterhead or written letters does not mean that some information need not be disclosed. The prospect or client must understand who you are, what you sell, and who you represent without any surprises.

During this opening interview, basic client data is obtained to spot planning exposures, which are then communicated in an attempt to disturb the prospect so that there is a desire to find a solution. Sometimes, to make the client afraid, graphics are employed. The graphics must not be misleading and must match the prospect’s level of understanding. A test might be whether the graphics, standing alone, need no further explanation to be understood, even years later.

Sometimes testimonials are employed to buoy credibility. In this case it is important to be sure that the testimonial reflects the current opinion of the endorser. There is also an obligation to disclose any financial consideration paid for the endorsement or whether the endorser has any interest in the agent’s business.

The process of fact-finding is very important. An agent has a duty to make a diligent effort to discover all circumstances that may be relevant to the client’s financial situation. Frequently, the client does not understand the impact of seemingly irrelevant and remote information.

For example, in determining whether there is an estate tax issue, retirement planning, gift planning, and the use of assets in retirement need to be assessed first in order to determine whether the estate is likely to shrink or grow in the future. Without determining a retirement plan, it may not be possible to provide reliable advice for estate planning purposes. If advice is provided without sufficient backing data, an agent can be liable if a client decides he is dissatisfied. It doesn’t matter that the reason for not having the information was the client’s unwillingness to provide it rather than the agent’s failure to ask for it.
Proceeding without adequate information is proceeding at your own peril.

When fact-finding, questions must be framed carefully so as to avoid unfairly leading the prospect to a particular conclusion. Moreover, care should be taken so the prospect is not given the impression that you provide services that you, in fact, do not. This would be tantamount to a misrepresentation. For example, detailed questioning about a client’s investment portfolio when the agent does not provide investment advice, or using a fact-finding form labeled in large letters “FINANCIAL PLANNING FORM” when only insurance services and products are provided by the agent, can lead to mistaken conclusions.

The financial services professional has the responsibility to avoid any situation that could reasonably be expected to mislead the client and to correct any misunderstanding as soon as its existence becomes apparent.

**Presentations and materials**

The purpose of the presentation/recommendation stage is to offer solutions to the eye-opening problems revealed. The principal compliance problems in this step involve product selection and communication.

In dealing with product selection, suitability is the key. We will discuss the issue of suitability later, but for our immediate purposes, the product selected must objectively and subjectively suit the client’s needs. In relating back to the fact-finding stage, suitability is determined by the examination of all of the client’s relevant financial information. The security industry’s “Rules of Fair Practice” specifically require suitability in light of the client’s other holdings, needs, and financial situation. Ethics requires that this doctrine be applied regardless of whether the transaction involves a security.

Perhaps the greatest compliance challenge involves how the product is presented to the client. Herein lies the inherent conflict of interest: as financial services professionals we pride ourselves on quality, objective advice, services, and recommendations, but as commissioned salespeople, we want to close the sale. As a result, there is tremendous temptation to place a product in the best light, rather than in an honest light. Human beings succumb to temptation on a regular basis – thus, the challenge of accurate product presentation.

Even where honesty, truthfulness, and true objectivity are pervasive, products are sometimes characterized as simpler than they actually are. To educate a consumer means merely to explain the unknown in terms of the known. But these kinds of explanations have a high probability of misleading a client. For example, in trying to describe a variable annuity, an elegant
description might be a family of mutual funds under a tax-advantaged umbrella. Unfortunately, this explanation leaves out more information that it imparts. Therefore, a client with little pre-existing knowledge of annuities will likely have an erroneous understanding of the true nature of variable annuities as a result.

Another example might occur when jargon is not properly explained. Dividends received by an insurance policy owner cannot be considered investment returns. Without a specific explanation to the contrary, it is quite reasonable for the lay client to be under the impression that such dividends represent some kind of profit rather than a return of excess premium. It would be inappropriate and unethical to knowingly allow such a misconception to go uncorrected. Similarly, life insurance itself should not be referred to as an investment.

**Product comparison issues**

Comparisons among products are fraught with problems. Comparisons between dissimilar products cannot be accurate or ethical unless all of the differences are compared. For example, comparing the rate of return between a CD and a growth stock is meaningless and misleading unless differences in risk, guarantees, tax features, etc. are compared. Any comparison information given to or explained to a client must be balanced and must discuss the pros and cons of each product.

Perhaps one of the most common forms of misleading comparisons occurs with the “spreadsheeting” of competing products. This is especially common in the field of Long-Term Care insurance. Typically, a spreadsheet sales piece will purport to contain quotations for a “sample policy” from several carriers. In other charts, the carriers will be along one axis while selected alternate ages or benefit levels will form the other axis. Such a spreadsheet of comparisons is misleading *per se* if given to a client as the basis for decision-making, for many reasons.

- Different companies have different contracts with different contract language.
- Not all LTC companies offer policies with the same choices of inflation riders, benefit periods, elimination periods, etc.
- Financial ratings, claims payment histories and premium stability of the carriers vary widely.
- Some policies may be tax-qualified others may not be.
- Some policies may be NYS partnership plans, others may not be.

This approach further strengthens the client’s misconception that Long-Term Care Insurance (or any other insurance, for that matter) is merely a
commodity – that all policies are the same with different price tags. Such an attitude undermines the value of our services, yet “spreadsheeters” perpetuate this damaging perception.

While the intentional misstatement of information would clearly be a compliance and ethics problem, the intentional omission of material information is no less improper. Specifically, IRC § 7702B requires that a Long-Term Care policy be sold to a client only after suitability has been established.

Statistics and numerical information used in any presentation must be current, relevant, and verifiable. The source should also be referenced.

Illustrations
Technically, an illustration is the numerical presentation of a product. The intent of an illustration is to provide sufficient balanced information to allow a client to make an informed decision.

Illustrations need to be complete. Virtually all insurance companies have computer illustration systems designed to produce compliant illustrations. However, non-compliance is usually the fault of the agent. Life insurance illustrations may appear to be unwieldy in length, with 15 – 20 page life insurance illustrations not uncommon. Sometimes, in trying to simplify his materials, an agent may decide that only a few of the given pages are needed. Invariably, those pages selected highlight the positive factors being emphasized by the agent. Of compliance concern is the intentional omission of the remainder of the illustration, which is needed to present a balanced picture and avoid misleading the client.

Illustrations need to be uncontaminated. It is very common to see an illustration marked up by an agent – containing stars, arrows, lines, and highlighting. The compliance concern with adulterating an illustration (or any other required disclosure) is that such marks may be seen as a representation that those items are more important than anything else. If the reader was supposed to pay attention to certain portions of an illustration over others, the illustration would have so indicated – large letters, bold print, etc.

In addition to being provided with a complete copy of any illustration discussed, the client must also be educated as to what an illustration really means. It is a projection of the future based on certain assumptions. In fact, it is nearly a certainty that the projections made in the illustration will not occur. Policy performance may be better or worse than that illustrated. The lay client has a tendency to believe what is in writing is promised and will occur. The true
nature of an illustration should be explained, along with the product’s risks and rewards.

“Vanishing” premiums
Managing client expectations is actually the job we do as advisors. We know that if a life insurance policy performs in a certain manner, the period of time during which a policy owner needs to make premium payments can be abbreviated. This concept of “vanishing premiums” has caused a great deal of litigation against insurance companies as well as enormous frustration on the part of clients. Under the theory that a client believes what she sees in writing, illustrations frequently show an ending of premium payments, but the continuing of the policy.

The mere phrases “vanishing premium,” “abbreviated premium payment period,” and words of similar import are misleading and inaccurate in and of themselves. In reality, the premium doesn’t vanish or stop. The premium continues to be paid, and it continues to be paid by the policy owner. Instead of the premium being paid by check of the policy owner, the premium payments come from another pool of money that has developed in the policy as the result of good performance of the non-guaranteed elements contained in just about every permanent life insurance policy.

Although a complete discussion of life insurance is beyond the scope of this course, every client purchasing permanent life insurance should be apprised of the fact that certain elements of their contract may not be guaranteed. The non-guaranteed elements may vary with the type of insurance purchased (whole life, universal life, variable life) and may include one of more of the following: credited interest rate, dividend rate, dividend existence, mortality costs, loadings and expenses, separate account rate of return. Although conservative illustrations may be run, enhancing the ability to achieve a certain result, the client must understand that the premium never really vanishes, and that perhaps a little bit of serendipity may be needed to achieve a planned termination of the need for out of pocket premium payments. Moreover, even if the premium does “vanish,” the client must be made to understand that future adverse policy performance may result in the reappearance of the need to write premium checks.

Company-provided illustrations are generally compliant. Illustration compliance problems occur when incomplete or marked-up illustrations are used or when they are supplemented by agent-provided spreadsheets or other literature. Any such additional sales literature of information used should be submitted to the companies represented for compliance approval. In many cases,
the agent or broker’s contract will require that in the small print. Ethically, it is the agent’s duty to do so as under the law of agency, the companies represented may be liable for an agent’s acts.

**Implementation**

Most of the compliance problems during the sales process have been touched upon and occur prior to or at the time the client signs the insurance application. There are some compliance concerns focusing on agent conduct after the sale occurs. These concerns involve the failure to obtain proper coverage and the failure to maintain proper coverage. Although these problems are seen more commonly on the property and casualty side of the business, they can occur on the life side as well.

Failure to obtain proper coverage may result from:

- Failing to properly analyze the client’s situation and the risks involved;
- Failing to request the proper coverage;
- Improper delays in requesting coverage; and
- Failing to receive the proper coverage from the insurer.

Failure to maintain proper coverage may arise from:

- Failure to renew coverage on a timely basis, or
- Failure to notify insured of non-renewal.

**Suitability**

Suitability is not only a modern issue, but in today’s world of compliance, it has taken on new importance. As we, either voluntarily or involuntarily, take on the task of being an advisor and dispensing advice on strategies or regarding products, we will be held accountable if we make unsuitable recommendations.

Although suitability determination is not an exact science, it always requires that fact-finding precede recommendations. The fact-finding must be more than cursory or the perfunctory execution of a meaningless duty. It must be deep, insightful, and designed to gather relevant information. We are, after all, nothing more than financial cartographers.

Our duty is to draw the financial protection map to assist a client in moving from point “A” (current location) to point “B” (goals and objectives). Obviously,
we can’t do that without knowing in advance where points “A” and “B” are.

**Long-Term Care Insurance Suitability**

Long-Term Care insurance (LTCI) can be offered in a tax-qualified format and a non-tax qualified format. The former provides certain tax incentives (potential premium deductibility; tax-free benefits) and standardized claim definitions but potentially more restrictive access to benefits. Fact-finding needs to occur to determine whether tax benefits are real or illusory in each particular case.

In the state of New York, LTCI is also available in its traditional form as well as in the form of the NYS Partnership Plan. The latter may prove a less expensive alternative for some, while providing access to services for the rest of their lives, either paid for by an insurance company or by Medicaid. The purpose of the NYS Partnership Plan is to encourage the private purchase of LTCI to reduce the need for Medicaid expenditure early in the process. It allows Medicaid qualification without the need to spend assets down to levels of impoverishment. However, fact-finding needs to occur to determine whether the non-protection of excess income or the potential portability restrictions of the Partnership Plan can harm a particular client. In addition, some may view qualification for Medicaid as not being a laudable goal in the first place.

Finally, LTCI is available with a myriad of potential coverage limits and riders. Fact-finding needs to occur to determine what area of the country the client will be retiring in as the costs of long-term care vary widely throughout the US – and even in the state of New York.

**The Variable Annuity**

There is an ongoing raging controversy over the applicability of variable annuities in IRAs and qualified plans. The detractors of such usage say that since both the annuity and the qualified plan or IRA are both tax-deferred, the extra expenses associated with annuities are unwarranted. Since you can’t benefit from two raincoats in the rain, why pay for both? They further argue that the death benefit is not very meaningful. When required minimum distributions begin or when withdrawals occur prior to the required beginning date, the death benefit is adjusted downward to account for the amounts withdrawn. They also point out that there is no additional probate protection, as IRAs and qualified plans have designated beneficiaries that avoid probate as effectively as an annuity’s beneficiary designation.

The proponents argue that annuities are the only vehicles that can guarantee a lifetime of income that cannot be outlived – even if the annuitant is
the proverbial Russian eating yogurt living to 140. Furthermore, annuitization of a variable annuity can provide some inflation protection of lifetime income.

Obviously, there are some persuasive arguments on each side. What is appropriate and suitable, however, depends on the facts and circumstances of each case. Therefore, extensive fact-finding needs to occur to understand the client’s goals and desires as well as his or her current financial condition.

Both the NASD and SEC have publicly criticized the sale of variable annuities in qualified plans and in IRAs. They stopped short of declaring it wholly unsuitable, as it could be suitable in certain cases. However, what they did indicate lacking suitability was the sale of variable annuities in retirement plans without the individual determination of appropriateness in each case.

In NASD Notice to Members 96-86, the NASD reminds its members and registered representatives of their obligation to review suitability in the sale of variable annuities and variable life contracts. They are “…required to make reasonable efforts to obtain information concerning the customer’s financial and tax status, the customer’s financial objectives and such other information used or considered to be reasonable…” in making recommendations to the customer. NASD Notice to Members 99-35 revisits this issue, setting forth more specifically the type of fact-finding needed.

**Life Insurance in Qualified Plans**

Although life insurance cannot be owned in an IRA, it can be owned in qualified retirement plans. It is common in the case of small businesses to install a type of qualified plan called a profit-sharing plan and to use some of the assets in the plan to purchase a large amount of insurance. Although there are restrictions which may limit the amount of life insurance which can be purchased, there are also ways to circumvent the restrictions.

The retirement plan assets used for life insurance premiums are no longer able to provide retirement benefits. Upon a death, the life insurance proceeds will be part of the retirement plan and income tax liability will attach to the proceeds, which could have been income-tax exempt under IRC §101 if not in the retirement plan. Finally, the face amount of the death benefit can also be included in the decedent’s gross estate. Some creative attempts to improve this outcome are available, but as of this time there is little in the way of settled law on their effectiveness.

Sometimes, however, the retirement plan is the only place where there are sufficient assets to pay the life insurance premium. Moreover, the life insurance
is being paid for with largely pre-tax dollars – providing significant tax leveraging.

Fact-finding needs to be very complete in this complex area of practice.

**P & C EXAMPLES OF UNSUITABILITY**

Property and Casualty is not the “hot” area when it comes to agent or broker wrongdoing. This is not to say that it is an area without problems; however, most of the problems are fairly straightforward.

Under the principles that every client is entitled to full disclosure by an insurance agent, and that an insurance agent is duty-bound to adequately ascertain sufficient information in order to form suitable recommendations, there are a few issues which bear some mention at this time.

**The pollution exclusion issue**

Ever since insurance companies discovered the mammoth costs involved in environmental clean-ups of spills, leaks and discharges of hazardous and toxic materials, they have taken great pains to eliminate or limit their liability in these cases. We can assume that when a business has the need for such insurance, it will engage competent counsel and insurance consultants to research and obtain appropriate coverage. Although this may be an invalid assumption is some cases, we may more validly assume such counsel and consultation is regularly NOT sought by homeowners.

**The duty to defend**

Corporate risk managers have long recognized liability insurance as litigation insurance. Often, the cost of retaining counsel can rival the monetary amount of the loss. Just how broad is the insurer’s duty to defend? The majority view is that the duty to defend is triggered not only when examination of the claims in the lawsuit suggests the possibility of coverage, but also when facts outside the “four corners” of the litigation documents suggest there might be coverage. The New York Court of Appeals has stated that the duty to defend is a form of litigation insurance for which a policy owner specifically pays a premium when it buys a policy.

A problem when dealing with this issue is that the breadth of the duty can vary widely depending on jurisdiction. Some jurisdictions may relieve an insurer of the duty to defend simply looking within the documents, while others may relieve the insurer of this duty based solely on facts outside the four corners.
**Coverage for damage due to terrorism**

With a business all-risk property insurance policy, once the insured suffers a loss, the burden of proof to show there is no coverage shifts to the insurer. The policy covers *all risks*, except for those specifically excluded. In contrast, a named-perils policy covers only those perils explicitly listed.

The types of losses a business may suffer when victimized by terrorists can include (among others):

- Income losses due to business interruption;
- Obligation of expenses continuing during interruption;
- Business owner property damage;
- Third party property damage;
- Interference with ingress and egress;
- Losses due to other costs expensed for loss prevention; and
- Physical injury and death.

Many insurance policies do not have an exclusion specifically for terrorism. They may exclude losses due to war and military actions, which have been held *not* to apply to hijackings. Although a formal declaration of war may not be required to invoke this exclusion, some evidence that a sovereignty’s military has been engaged in a conflict is required. Exclusions for insurrection, rebellion, revolution, usurped power or action taken by a governmental authority in hindering or defending against any of these also appear not to exclude terrorism due to definitions which have been assigned to them by courts and various commentator in treatises. Even civil commotion exclusions have been held not to apply to a hijacking. Where there is a specific terrorism exclusion, it needs to be examined carefully. The insurer has the burden to provide applicability of the exclusion.

Aside from determining applicability or non-applicability of an exclusion are the issues of proving efficient proximate causation, providing notification of loss and cooperation with the insurer in the claims process. All of these issues, interesting as they may be, are beyond the scope of this text.

**Mutual Fund Shares**

Mutual funds are investment companies formed under the Investment Company Act of 1940, and they are designed to pool investments from many investors. Each investor owns a proportional undivided interest in the mutual...
fund and in each of the mutual funds underlying investments. The investor’s ownership interest is represented by her shares in the mutual fund.

Although an investor can purchase mutual funds without sales charges (loads), those investors who deal with financial advisors and want their assistance will usually pay for that assistance in the form or commissions or loads. Mutual fund shares are sold with three basic commission structures, denoted as “A” shares, “B” shares and “C” shares.

“A” shares have a front-end commission structure – a percentage of the client’s investment is removed prior to actual investment of the remainder. A client investing $100 in “A” shares with a 5% load will actually see $95 dollars invested. If the investment were in “B” shares, $100 would be invested but if the investment were to be terminated within the first 6 years a declining percentage would be lost as a contingent deferred sales charge (CDSC), typically 6% after 1 year, 5% after 2 years, etc. In addition, “B” shares will have higher expenses (often about 0.75% per year) than “A” shares resulting in a lower rate of return on invested assets. Finally, after some period of time (usually 7 – 10 years), “B” shares turn into “A” shares. In the case of “C” shares, there is no front load, only a 1% CDSC for only 1 year. “C” shares also have higher annual expenses (about 0.75% per year) and never turn into “A” shares.

A registered representative must explain these three commission structures to the client and, based on fact-finding, help the client decide which alternative is best. Actively concealing the loads by offering only “B” shares (no front-end load still paying full commission) is an unethical activity. The NASD has been active in those instances where a registered representative has engaged in a practice of selling only “B” shares. The position of the NASD is that there is a rebuttable presumption of concealment in such cases.

Generally, “A” shares are more appropriate for longer term investments, “C” shares are fit for shorter term investments and “B” shares best work as medium term investments. “B” and “C” shares do not provide the client with the ability to take advantage of break point pricing (reduction of sales load for larger volume dollar sales). Therefore, a pattern of selling shares with CDSCs may indicate a need to maximize the registered representative’s commission rather than operate in the client’s best interest.

Food for Thought
Revisiting Innocent Misrepresentation

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Intentional misrepresentation with the goal of deception so as to profit as a result is called fraud. What is an innocent misrepresentation? Is it the same as negligence? Think about whether you have ever participated in the unethical behavior pointed out in this chapter, and how you can correct such instances in the future.
Chapter 4:  
Common Compliance Problems

In determining producer liability, the courts generally ask:

- Was there a duty owed?
- Was there a breach of that duty?
- Was there damage as a result of that breach?

The claims against producers frequently fall into the following categories:

- Failure to procure coverage requested;
- Failure to procure any coverage;
- Failure to procure adequate coverage;
- Failure to advise of inability to procure coverage;
- Failure to advise as to changes in coverage;
- Failure to renew coverage;
- Failure to update coverage;
- Placement of insurance with an insolvent carrier; or
- Failure to notify as to cancellation.

Breach of Fiduciary Duty to the Insurer

The agent owes a fiduciary duty to the insurer as well as owing a fiduciary duty to the client. This relationship necessitates a high degree of trust and confidence, as the agent is acting as another’s representative. It requires more than just fair dealing. These duties can be amended by contract, but where not addressed in the contract they are implied by operation of law. Following is a brief examination of duties owed to the insurer.

Duty of loyalty

This includes the duties of due diligence and good faith in performance as well as a responsibility to avoid serving conflicting interests.
Careful solicitation
The duty of careful solicitation means refraining from engaging in a business that requires a skill set or special abilities not possessed by the agent or the insurer. This duty also includes taking reasonable care in all acts on behalf of the carrier.

Disclosure
The agent has an absolute duty to make full disclosure of all pertinent information bearing on an application for insurance. Where there is a question of whether a particular condition should be disclosed, always err on the side of disclosure.

Many agents feel that their duty is owed primarily to their client, and that the function of an agent is to present the client in the best possible light to receive a good underwriting offer. Actually, this is not true. In fact, the implication of such a thought is that the true facts are to be colored in some way to provide the client with some benefit which might not have been available had the agent been more forthcoming. The difference between this and fraud may be only a matter of degree.

If an insurer is found to be bound by a policy fraudulently induced by the agent, the agent may well have liability to the insurer for his or her actions.

Duty to solicit profitable business
It is a waste of an insurer’s time, money, and other resources to review applications from prospects that don’t qualify. Insurance agents are frequently referred to as field underwriters. As such, some decisions should be made in the field as to the health of the subject (if life or health insurance is being considered) and financial ability to pay the premium. Obvious field screening should occur for issues like insurable interest and suitability. Finally, some determination should be made that a lapse is not a likely short-term result.

Duty to complete the business
Once business is written, the agent has a duty to see it through to completion within a reasonable time. There may be risks to the insurer if applications are not completed timely or if policies are not delivered in a timely manner – especially if a binder exists. Furthermore, time kills deals. The failure to follow a case through to completion in a timely manner may result in loss of a client’s interest and, eventually, lead him to take his business elsewhere.

Account for funds
Finally, the agent has a duty to account for premiums collected. This, of course, is necessary for ethical reasons and because of state and federal laws.
course, assumes that the agent has the authority to collect premiums. This authority is usually contained in the agent’s contract. The insurance company’s funds should be remitted promptly to the company and should never be commingled with personal funds.

**Breach of Fiduciary Duty to Client**

New York Insurance Law codifies the fiduciary duty owed to a client in §2120. Let there be no doubt that such a duty exists. The fulfillment of client expectations and satisfaction of the duties owed depends in large measure on the particular standard of care to be used. This, in turn, depends to a great extent on whether the agent has been presented as an expert or professional in the field.

**Client first**

The very essence of a fiduciary relationship with the client means acting for the client’s benefit and putting the client’s interests ahead of the agent’s.

For example, if a client qualifies for a group discount but is not aware of it, the agent is obligated to inform the client – even though it frequently reduces the agent’s commission.

**Suitability**

We’ve discussed suitability at great length, but it should be understood that an insurance agent has a fiduciary obligation to make appropriate recommendations and sales. Be aware that even when volunteering or offering advice or an opinion, an agent has a legal duty to exercise reasonable care and may be held liable for negligent advice.

**Churning, twisting**

Churning and twisting refer to excessive trading in a client’s account for the sole purpose of generating commissions. In the life insurance business, twisting frequently takes the form of improper total replacements of insurance policies or annuities, or the borrowing from one policy to finance the purchase of another.

The fact that a transaction will not hurt a client is not sufficient reason to recommend it. In addition, there should be no tolerance at all for churning or twisting in any form.
Rebating
Rebating is the giving or promising of something not included in the insurance contract to a client as inducement to make a sale or to continue the persistency or a prior sale. As discussed earlier,

- it may encourage replacements;
- it may allow similarly situated individuals to be treated differently for reasons not related to the insurance; and
- it may encourage rampant and cutthroat competition destructive to the profession.

Meaningful disclosure
Honesty is a necessary part of any fiduciary relationship, and it cannot be emphasized strongly enough.

Meeting reasonable client expectations
The insurance financial services business as a whole is founded on managing client expectations. Clients frequently don’t know what reasonable expectations are until they understand the processes involved in meeting expectations. Part of our duty to our clients is helping them determine what is reasonable and then assisting them to implement strategies to achieve those objectives.

Complete the business and account for funds
Once a client gives us a check for investment, as a deposit for a binder on application or as a first premium payment in acceptance of an insurer’s offer, an agent has a fiduciary duty to process and/or forward that payment in a timely fashion, completing all acts necessary to underwrite an application or enforce accepted business.

The policy replacement issue
Policy replacement is both a legal and an ethical issue. When replacement is done illegally, it is always unethical. When it is done legally, the professional life insurance producer must still be careful to make sure that the replacement meets ethical standards, which would include adherence to the producer’s duty to disclose all material information and always act in the best interests of the client.

Replacement of existing life insurance policies has become increasingly tempting to both producers and consumers. But replacements have to be evaluated carefully and completely. There are many factors to be considered, and rarely does replacement leave a policy owner better off in every way. Usually he
will give a current benefit in hopes of obtaining a greater benefit in the future. Replacement may be justified in such circumstances, but only if it comes as a result of the policy owner’s decision after a full and fair analysis of all the pertinent facts.

The NAIC has adopted the Life Insurance and Annuities Replacement Model Regulation and various states have passed legislation to address inappropriate life insurance policy replacement. The Model Regulation does not, however, include a financial decision framework that provides a measure of the performance of the existing policy, especially in terms of suitability and proper timing in a replacement decision.

Studies have shown that up to 93% of policies should not be replaced during policy years three through ten based on a hurdle rate of 5%. The methodology and findings are relevant to consumers, financial service professionals, insurers, and regulators.

**PARTIES AFFECTED BY POLICY REPLACEMENT**

**Producers of the existing policy**
The insurance company that issued the existing policy may be hurt by the proposed replacement, since one of its policies will be lapsed or surrendered, perhaps before its acquisition costs have been recovered. In addition, that company’s market will get a little smaller, since it is not likely to sell any more coverage to that policy owner.

The producer who sold the existing policy may lose renewal commissions if any would be paid on the policy, perhaps even first-year commissions if the replacement occurs very soon after the original sale. That producer’s client base will also be eroded.

**Producers of the replacement policy**
The company that issues the replacement policy will be affected positively by the acquisition of new business, but negatively if that policy is again replaced before the company’s acquisition costs are recovered. A policy owner who already replaced one policy may be more likely to replace the new one if he or she is later shown a better deal.

**The policy owner**
The policy owner has much more at stake than just economic benefits when replacement is proposed. Life insurance policy replacement can raise some disturbing questions that may diminish one’s peace of mind. Producers should be
sensitive to the fact that the issues they are raising when they propose replacement go beyond the economics of the situation.

Replacing a policy should be based on whether the client will be as well off, or better, after replacing one policy with a new one. When replacing existing life insurance, it is important to maintain a current policy until the new policy is approved. To accomplish this, an individual should apply for the new life insurance policy about sixty days before his premiums are due on the policy to be replaced. If, for some reason, he is not approved for the new policy, he can still maintain the old coverage. This is the safest and only way to replace life insurance.

**CONCERNS FOR THE POLICY MAKER**

- **Start-up Costs:** usually most new policies impose start-up costs; meaning one might be paying those costs twice.

- **Contestability:** most new policies contain a two-year period for both suicide and contestability. A replacement policy would restart the time-period, meaning that, under certain circumstances, benefits would not be paid within the first two years.

  If an individual has owned an insurance policy for over two years, it would pay off in the event of a suicide. The new replacing policy, however, will not cover suicide until the new policy has been in force again for over two years.

  If an individual misrepresents his health history -- like forgetting to tell the insurance company he has cancer-- it is still likely the insurance company will pay benefits if he dies after owning the policy for over two years. These two years represent the incontestability period. A new policy will start a new incontestability period.

  To avoid problems with contestability, an individual should make absolutely sure that he could qualify for the new insurance policy, while making full disclosure about his medical history. He should keep in mind that the incontestability provision does not mean that an insurance company can avoid paying a death claim if the individual dies in the first two years. However, they can avoid paying the death claim if he dies in the first two years and he has materially misrepresented his medical history.
Cost of the New Policy: how are guaranteed and projected policy values calculated? What is the true out-of-pocket premium cost on the new policy compared to the one being replaced?

Increased Premiums: this could happen if one is considering replacing a traditional whole life policy with term or universal life.

Tax Consequences: under some circumstances, the surrender of a policy results in taxable income. If the transaction qualifies as a Section 1035 exchange, taxation may be avoided.

Benefit Riders: the importance of riders such as a disability waiver of premium is often overlooked, but such riders add significant value to one’s policy.

Other Options: if one’s insurance needs have changed, there may be other options to consider instead of policy replacement such as enhancing an existing policy with a customized additional benefit or keeping an existing policy "as is" and buying another.

DISADVANTAGES OF POLICY REPLACEMENT

Misleading Projections
Replacement became a huge problem in the insurance industry in the 1970s and '80s when interest rates were high. Several relatively new and aggressive life insurance companies produced payout projections beating anything the traditional stalwarts were offering. But it was all a projection that most of the companies could not follow through with. Many of them were taken over by their state insurance commissions because they were insolvent, leaving the policyholders without insurance or a payout.

Notifications of Replacement
Partly out of a reaction to this bad situation and to make the insurance industry more professional, most life insurance applications now include a question asking if this new policy is replacing an old one. If so, the agent must provide a detailed explanation. Additionally, most states now require life insurance agents to file "notifications of replacement" with their state insurance commissions and to comply with various regulations.

High Costs
The consumer replaces investments all the time. Replacing a life insurance policy is different because the upfront costs are higher than when replacing other investments. There are:
• underwriting expenses
• marketing and administrative fees
• sales commissions

Those upfront fees often exceed the premium that one has to pay as well. Replacing term insurance does not matter as much, because one is generally buying by the numbers and seeking the cheapest policy for the time period needed.

The major problem is with permanent insurance, because the commissions are usually much higher than for term insurance and the consumer has the most to lose because of paying those commissions.

**REASONS FOR POLICY REPLACEMENT**

**Changed Needs**

The client’s needs may have changed. He may have been sold the wrong policy in the first place. He may need term instead of permanent insurance because he only needs the death benefit for ten years.

If an individual has cash value life insurance that is older (over ten years), it would be wise to reevaluate that coverage. Many policies issued over ten years ago were sold on a uni-smoke basis. This means that the insurance companies charged the same premiums for smokers and nonsmokers. Currently, insurance companies charge over twice the premiums for term insurance covering a smoker. If an individual is a non-smoker and is in good health, with a policy issued on a uni-smoke basis, he should investigate the possibility of replacing that coverage. If his coverage is pre-1982, it should be reviewed even if he is a smoker. Many newer contracts are much more consumer-oriented.

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There are several companies' policies written in the last ten years that probably should be replaced even if they were correctly issued as non-smoker policies. If an individual does not feel his current policy represents a good value, he should check with a knowledgeable agent to see if improvements can be made. If he is replacing his insurance, he should make sure that he indicates on the application for the new insurance that he is replacing his old insurance. This will insure that whatever replacement laws are required; they will be followed in each state.

**Misunderstanding of Original Policy**

A client may have purchased a permanent insurance policy that he did not understand. He discovers that he has a variable life policy requiring investment decisions on his part and having no guaranteed cash value. What he really wanted was a whole life or universal life policy where there are guaranteed cash values and he does not have to make any of the decisions.
Need for Cash
The client wants to pay off a large loan on the old policy by using its cash value.

Better Investment
Some clients discover that they purchased a permanent life insurance policy from a company that is not financially sound. They want to make a better investment.

Higher Interest Rates
A client may have purchased a policy in the 1970s or before and the guaranteed returns of 2% to 3% are so low that replacing them with new ones actually does make sense.

Lower Commission Rates
A client may be in the first three years of a permanent insurance policy for which he paid commissions. He may decide that he would be better off starting over with a new low-load, no-commission policy.

The In-Force Ledger
An “in-force ledger” is how one’s existing policy is expected to perform from now on. When comparing an existing permanent insurance policy and a new policy with a client, the agent must use an “in-force ledger.” He can compare the two policies year-for-year in this way.

Calendar Years
He should compare calendar years, not years of the policy. If the client has owned a policy for five years, the agent should not compare the fifth-year values of the old policy with the fifth-year values of the new policy. If he does he is comparing differences in guaranteed and illustrated cash values and death benefits for current and future calendar years. Unfortunately, this is a sales technique that has often been used to persuade life insurance owners to switch policies.

Tax-Saving Provisions
The final issue to consider is whether one’s old policy has important tax savings provisions that have been grand fathered in from any tax changes in subsequent years. The changes could be worth thousands of dollars to the policy owner.
POLICY REPLACEMENT AND TAX LAWS

When an individual owns a life insurance policy, he may be approached to exchange it for another new policy. He needs to know that even though the tax laws make the exchange income tax free and the new policy may appear better to him, he may be losing - not gaining - if he makes the exchange. Since variable products are securities, the National Association of Securities Dealers (NASD) wants to give information to help agents and consumers evaluate whether the exchange is right for them, and how one can find out what he needs to know to make an appropriate decision.

Types Of Life Insurance
There are various forms of life insurance products. Although features and benefits may vary, the following is a general description of typical characteristics of various types of life insurance policies.

- **Term Life Insurance.** Term life insurance provides coverage for a specified and limited period of time (the "term"). Premiums for most term policies increase with age or at the end of each renewal period. After the policy or term ends, there is no benefit payment if the insured person survives beyond the policy period.

- **Whole Life Insurance.** Whole life or ordinary life insurance is a form of permanent life insurance. This means it can provide coverage for the life of the insured. It also can build cash value, which is a savings feature. Premium payments typically remain level for the life of the insured.

- **Universal Life Insurance.** Universal life insurance can also provide coverage for the life of the insured while at the same time providing flexibility in premium payments and in insurance coverage. The cost of insurance protection and, in some cases, other costs are deducted from the cash or policy account value.

- **Variable Life Insurance.** Variable life insurance, a variation of whole life insurance, offers a fixed premium schedule and a minimum death benefit. But it differs from traditional whole life insurance in that cash values are invested in portfolios of securities in an account separate from the general assets of the insurance company. A policyholder has discretion in choosing the mix of investments the policy offers. The insurance company does not guarantee investment returns and your cash value will fluctuate.
Variable Universal Life Insurance. Variable universal life insurance combines features of universal life insurance and variable life insurance. Most variable life insurance policies and variable universal life insurance policies are securities registered with the Securities and Exchange Commission (SEC). Registration requires that investors receive important financial and other significant information concerning the securities being offered for sale. This enables investors to judge for themselves if the securities are a good investment. These regulations also provide important remedies to investors if they can prove that there was incomplete or inaccurate disclosure of important information provided to them.

1035 Exchanges
The Internal Revenue Service allows a policy owner to exchange an insurance policy that he owns for a new life insurance policy insuring the same person without paying tax on the investment gains earned on the original contract. This can be a substantial benefit. Because this is governed by Section 1035 of the Internal Revenue Code, these are called "1035 Exchanges."

But this benefit comes with some important strings. The tax code says that the old insurance policy must be exchanged for a new policy—the policy owner cannot receive a check and apply the proceeds to the purchase of a new insurance policy.

The tax code also says that he can make a tax-free exchange from:

- a life insurance policy to another life insurance policy or
- a life insurance policy to an annuity

He cannot, however, exchange an annuity contract for a life insurance policy.

A transaction in which a new insurance or annuity contract is to be purchased using all or a portion of the proceeds of an existing life insurance or annuity contract is referred to as a "replacement." A 1035 Exchange is a type of replacement transaction. Although the term "1035 Exchange" is often used to describe any form of replacement activity, technically not all replacements are Section 1035 Exchanges and as a consequence are not tax-free.

Both variable life insurance and variable universal life insurance are securities. Those who offer these products must follow SEC, NASD, and state securities regulations, in addition to state insurance law. This means that a broker must tell the client the important facts about the pros and cons of the exchange. The broker or insurance agent should recommend such an exchange only if it is in the best interest of the client and only after evaluating his personal and financial
situation and needs, tolerance for risk, and the financial ability to pay for the proposed insurance policy.

**Replacing Life Insurance with Variable Annuities**

An annuity is a contract between an individual and an insurance company where the company promises to make periodic payments to him, starting immediately or at some future time. He buys the annuity either with a single payment or a series of payments. Annuity contracts come in two flavors: fixed and variable.

Fixed means that the earnings and payout are guaranteed by the insurance company. Variable means that the amount that will accumulate and be paid will vary with the stock, bond, and money market funds that you chose as investment options.

Unlike fixed contracts, variable annuities are securities registered with the Securities and Exchange Commission (SEC). The SEC and National Association of Securities Dealers (NASD) regulate sales of variable insurance products.

Variable annuities may impose a variety of fees when an individual invests in them, such as:

- **surrender charges**, which you owe if you withdraw money from the annuity before a specified period
- **mortality and expense risk charges**, which the insurance company charges for the insurance risk it takes under the contract
- **administrative fees**, for record keeping and other administrative expenses
- **underlying fund expenses**, relating to the investment options
- **charges for special features**, such as a stepped-up death benefit or a guaranteed minimum income benefit

The Internal Revenue Service allows you to exchange an insurance contract that you own for a new life insurance or annuity contract without paying tax on the income and the investment gains earned on the original contract. This can be a substantial benefit. Because this is governed by Section 1035 of the Internal Revenue Code, these are called "1035 Exchanges."

There are various reasons why a variable annuity contract holder may want to exchange an existing variable annuity contract. Many annuity contracts now offer premium – sometimes called bonus – credits toward the value of your contract, of a specified percentage ranging from 1-5% for each purchase payment you make.
Also, in recent years, there have been new developments in annuity features, especially in variable annuities, that are valid reasons to consider an exchange. The number of investment options has increased. Less expensive variable annuity contracts have been created. Death and living benefits have been enhanced. Also, with the growth in the stock market in the 1990s, many insurance contract holders have wanted to take part in that growth. These are all valid reasons for considering exchanging one insurance contract for another.

**THE LEGAL ISSUES IN POLICY REPLACEMENT**

The insurance agent should know what the law is in regard to policy replacement. Many times a sale may come under the legal definition of a replacement even when existing coverage remains in force. Even if an agent does not engage in any sales activity that involves replacement, the policies he has sold may be subject to replacement by other producers, so it will be useful to ascertain whether the replacing producer is complying with the law.

The specific regulations for sales involving replacement vary somewhat from state to state, but they are similar in many ways. To help protect the consumer’s interests, insurance companies and agents must follow certain requirements when they replace a policy or annuity. They must acquaint themselves with the particulars of the laws for the states in which they do business.

**Legal definition of Replacement**

An individual is "replacing" his current policy if he:

- lets it lapse, or forfeits, surrenders or terminates it
- converts it to a reduced paid-up policy, continues as extended term insurance, or otherwise reduces in value by use of nonforfeiture benefits or other policy values
- amends it to reduce benefits or terms
- has his policy or annuity reissued with a reduction of cash value
- pledges it as collateral or takes a loan against the policy for more than 25% of the loan value

Exceptions to the definition of replacement include the following in some states:

- credit life insurance policies
- group life insurance and annuity policies
- life insurance that is issued in connection with a pension
- contracts that are registered with the Securities and Exchange Commission (SEC), such as variable life insurance policies and variable annuities

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• non-convertible term life insurance policies that will expire in five years or cannot be renewed
• life insurance or annuity policies where the replacing insurer is the same company or under common ownership
• if the total cash surrender value is less than $500 and the face amount of the policy is less than $5000

**Consequences of Illegal Replacement**

The consequences of not complying with replacement regulations can be severe. Producers can be subjected to investigations or hearings conducted by the state department of insurance. This can result in severe fines, temporary suspension, or even permanent revocation of the producer’s license. Sometimes the company may be required to reimburse policy owners or pay lawsuits filed by policy owners.

Sometimes federal intervention is considered necessary to solve the problem. Federal intervention can be designed to discourage all forms of replacement. Consequently it is in the best interest of all for insurance companies to make sure that they adhere to the ethical standard of putting the client’s best interests ahead of their own self-interest in any life insurance transaction.

**Food for Thought**

*The strategic alliance*

Strategic alliances began gaining popularity after the AICPA and state CPA societies made determinations that it is acceptable for a CPA to earn additional fees and commissions from their clients by selling insurance and investment products. CPAs are required to secure the appropriate licenses and must disclose to their clients that they will be earning a commission from the transaction.

With the ability to derive revenue from commissions and financial planning fees, the CPAs then may opt for one of four basic alternatives:

1. Get licensed and sell securities and insurance to their clients directly.

In order to be successful at this, the CPA would likely have to abandon some or all of his current business to become an insurance agent and registered representative. Most CPAs do not want to abandon their practices, so it is unlikely this model will provide significant additional revenue. Furthermore, no matter how learned a CPA is, he is usually not very knowledgeable when it comes to financial products.
(2) Get licensed, but enter into a relationship with outside expertise capable of making proper recommendations to the client, then splitting commissions with the outside expert.

This is a great model for revenue generation, as the CPA needs only to introduce the outside expert and revenue can result with little or no additional effort on the part of the CPA. However, many CPAs do not want to spend the time necessary to get licensed and view this type of an arrangement as one in which they will lose control of their clients. Also, CPAs generally are not the best marketers of new services.

(3) Refusing to participate at all in any sale or referral arrangement citing conflicts of interest and loss of independence concerns.

There remains a significant percentage of CPAs who believe that the ability to sell products to clients and generate revenue from those sales compromises the CPA’s independent judgment and results in a conflict of interest. They may reevaluate their position if they believe that their clients truly are their competitor’s prospects.

(4) Refuse to get licensed, but refers, looking for compensation creatively positioned.

These CPAs want the additional revenue but do not want to go through the trouble of getting licensed. More importantly, they do not want to disclose participation to their clients. This is obviously a compliance problem, as commissions cannot be paid to unlicensed persons. Couching commissions and fees as “consulting fees” does not change the unethical character of the payment. At best, it is a rationalization. In order for such payments to be legitimate “consulting fees,” payment would be due regardless of whether business was conducted.

Attorneys, on the other hand, have historically been restricted more closely than CPAs. Essentially, attorneys and non-attorneys may not have a business relationship where the non-attorney would have any right or ability to influence the attorney’s exercise of legal judgment. New York has very recently addressed the issue of multidiscipline practice for attorneys – the ability of attorneys and non-attorney professionals to joint forces in a business not providing legal services. In handout #14, information on the current position of the NYCPA Society as well as the New York State Bar Association is set forth.
Strategic alliances are possible with other professionals, such as stockbrokers, fee-only financial planners, banks and property and casualty firms. These relationships are treading new ground, as financial services professionals seek new ways to generate revenue and assist clients as the old ways become less profitable.

Let’s take a step back and examine the strategic alliance from an ethical perspective. Does forming such an alliance create a conflict of interest? What should be the terms of the alliance to make it both compliant and ethically correct?

Suppose an attorney you like personally begins to refer insurance business to you from his clientele, and he suggests that referrals will continue if you pay a referral fee of 20% of your commission for each case you close. He further states that he can bill this referral fee as a “consultation fee.” What ethical issues do you see? Can you pay the attorney as requested? If not, how can the situation be modified so the attorney can receive compensation?

Now let’s suppose that the attorney does not want any cash compensation, but wants business referred back to him in return. You have serious doubts about his competency in the estate and business-planning arena, which is your area of practice. What would you do?
Where do we go from here?

Being a compliant and ethical professional has been proven to reap rewards in the long run, even if taking the high road on moral and legal issues seems to be tedious at the moment. It will allow you to provide your clients with better services and prevent you from experiencing financial loss or a tarnished image as a result of legal action.

If we make a commitment to conducting business in an ethical manner, then we collectively stand a better chance of restoring insurance to its previous stature of honor and honesty.

As Warren Buffett, the finance mogul, says, “The insurance business is a fiduciary business. You get access to other people’s money under conditions where in many cases the other people have very little knowledge or control of where the money’s going. So you need a cop. We believe in the cop being very alert and quite tough – because businesses that generate investable float money from other people tend to attract foolish optimists and crooks.”

We should each be our own “alert” and “tough cop” when it comes to managing other people’s money.
The American College Code of Ethics

The Professional Pledge and the Canons. The Code consists of two parts: the Professional Pledge and the Eight Canons. The Pledge to which all CLU and ChFC designees subscribe is: "In all my professional relationships, I pledge myself to the following rule of ethical conduct: I shall, in light of all conditions surrounding those I serve, which I shall make every conscientious effort to ascertain and understand, render that service which, in the same circumstances, I would apply to myself."

The Eight Canons:

I. Conduct yourself at all times with honor and dignity.
II. Avoid practices that would bring dishonor upon your profession or The American College.
III. Publicize your achievement in ways that enhance the integrity of your profession.
IV. Continue your studies throughout your working life so as to maintain a high level of professional competence.
V. Do your utmost to attain a distinguished record of professional service.
VI. Support the established institutions and organizations concerned with the integrity of your profession.
VII. Participate in building your profession by encouraging and providing appropriate assistance to qualified persons pursuing professional studies.
VIII. Comply with all laws and regulations, particularly as they relate to professional and business activities.
NAIFA Code of Ethics

Preamble: Those engaged in offering insurance and other related financial services occupy the unique position of liaison between the purchasers and the suppliers of insurance and closely related financial products.

Inherent in this role is the combination of professional duty to the client and to the company as well. Ethical balance is required to avoid any conflict between these two obligations. Therefore, I Believe It To Be My Responsibility:

- To hold my profession in high esteem and strive to enhance its prestige.
- To fulfill the needs of my clients to the best of my ability.
- To maintain my clients' confidences.
- To render exemplary service to my clients and their beneficiaries.
- To adhere to professional standards of conduct in helping my clients to protect insurable obligations and attain their financial security objectives.
- To present accurately and honestly all facts essential to my clients' decisions.
- To perfect my skills and increase my knowledge through continuing education.
- To conduct my business in such a way that my example might help raise the professional standards of those in my profession.
- To keep informed with respect to applicable laws and regulations and to observe them in the practice of my profession.
- To cooperate with others whose services are constructively related to meeting the needs of my clients.

Adopted April, 1986
Board of Trustees
National Association of Insurance and Financial Advisors
2901 Telstar Court, Falls Church, VA 22042

CPCU Society's Creed

As a member of the CPCU Society,
I will use my full knowledge and ability to perform my duties to my client or principal and place their interests above my own.

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I will use due diligence to ascertain and understand the needs of my clients or principal and will only undertake assignments that I can perform in a proper and professional manner.

I will faithfully present material facts in insurance and risk management business dealings in accordance with my duty and obligation. I will honor the confidential relationship that I have with my client or my principal.

I will obey and uphold any law or regulation duly enacted by any government body whose authority has been established by law.

I will abide by the ethical practices set forth in the Bylaws of the CPCU Society and only engage in practices which reflect well on the Society and the business of insurance and risk management.

I will write, speak, and act as an official representative of the Society or as a chapter of the Society only if I have been duly authorized to do so.

I will accurately represent the nature and significance of the CPCU designation.

The Institute of Electrical and Electronics Engineers’ Code of Ethics

We, the members of the IEEE, in recognition of the importance of our technologies in affecting the quality of life throughout the world, and in accepting a personal obligation to our profession, its members and the communities we serve, do hereby commit ourselves to the highest ethical and professional conduct and agree:

1. To accept responsibility in making engineering decisions consistent with the safety, health and welfare of the public, and to disclose promptly factors that might endanger the public or the environment;
2. To avoid real or perceived conflicts of interest whenever possible, and to disclose them to affected parties when they do exist;
3. To be honest and realistic in stating claims or estimates based on available data;
4. To reject bribery in all its forms;
5. To improve the understanding of technology, its appropriate application, and potential consequences;
6. To maintain and improve our technical competence and to undertake technological tasks for others only if qualified by training or experience, or after full disclosure of pertinent limitations;
7. To seek, accept, and offer honest criticism of technical work, to acknowledge and correct errors, and to credit properly the contributions of others;
8. To treat fairly all persons regardless of such factors as race, religion, gender, disability, age, or national origin;
9. To avoid injuring others, their property, reputation, or employment by false or malicious action;

10. To assist colleagues and co-workers in their professional development and to support them in following this code of ethics.

Approved by the IEEE Board of Directors, August 1990

IMSA’s Principals and Codes, Annotated

Each life insurance company subscribing to these principles commits itself in all matters affecting the sale of individually-sold life and annuity products:

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

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

3. To engage in active and fair competition.

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

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

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

Comment: The Principles are designed to set out general standards that are universally agreed upon. The Code specifies the means for achieving the broad Principle statements. The "Comments" within the Handbook are designed to provide further guidance and clarification as to the intent of the Principles and Code of Ethical Market Conduct. The Principles, Code, and Comments are integral to each other and must be viewed together as parts of a whole design. The Handbook, Principles, Code and Comments are intended to apply to covered products and are intended for use by companies in their U.S. operations.

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

To conduct its business according to high standards of honesty and fairness, an insurer will implement policies and procedures designed to provide reasonable assurance that:

Code A. The insurable needs or financial objectives of its customers are determined based upon relevant information obtained from the customer and the company enters into transactions which assist the customer in meeting his or her insurable needs or financial objectives.

Comment: The marketing and sale of covered products may often encompass practices other than "needs-based selling." Customers may have legitimate
financial objectives that go beyond what may be fairly characterized as "insurable needs." It must also be recognized that in some instances it may not be practical or appropriate to consult individually with each customer. For example, in mass-marketed direct response sales, the structure of the product design and its intended markets may satisfy the requirements for determining insurable needs or financial objectives.

**Code B.** It maintains compliance with applicable laws and regulations.

Comment: Code B of this Principle is intended to focus on a company’s system or process for complying with laws and regulations which apply to the products within the scope of the Principles and Code of Ethical Market Conduct. It is not intended to determine the company’s actual compliance with such laws and regulations.

**Code C.** In cooperation with consumers, regulators and others, it affirmatively seeks to improve the practices for marketing and sales of covered products.

**Principle 2:** To provide competent and customer-focused sales and service.

Comment: There seems to be a consensus on the value of having a central source for information about distributors’ prior history, including disciplinary involvement. Such systems are becoming available; for example, the NAIC Producer Database ("PDB") or an alternative source such as the NASD Central Registration Depository system ("CRD"). Whether through these systems or others, companies should now utilize some independent source for checking on the history of distributors before entering into a relationship with them and such a source could be helpful in making decisions about continuing existing relationships.

Company actions appropriate in complying with Principle 2 will differ among companies according to the relationship between a company and its particular distribution system. For example, the relationship between a company and its career agents is significantly different from that of another company which uses brokerage relations with distributors, which in turn is different from companies distributing products through securities brokers or banks. Indeed, some companies within an affiliated operation utilize many different distribution structures for different or the same products. A company may fulfill its obligations under Principle 2 by relying on its managing general agents or other third parties, depending upon the nature of its distribution system and agency contractual provisions. However, a company is accountable under Principle 6 (the "supervision" provision) for carrying out these Principle 2 responsibilities.

To provide for competent sales and service of covered products, a company will develop policies and procedures designed to provide reasonable assurance that:

**Code A.** Its captive and independent distributors and appropriate company employees are of good character and business repute, and have appropriate qualifications

Code B. Its captive and independent distributors and appropriate company employees are duly licensed, appointed or otherwise qualified under state law.
**Comment:** Principle 2, Code B is designed to address a company's use of persons who have complied with state-mandated licensing requirements in selling its products. Efforts at substantiating that its distributors are authorized by state law to sell is the focus of this Code provision. Some states permit distributors to engage in sales activities of insurance products prior to issuance of a license, and the same substantiation effort is appropriate in such situations to assure that such distributors are qualified under state law to write insurance.

**Code C.** Its captive and independent distributors and appropriate company employees are adequately trained, as appropriate to the company's distribution system.

**Comment:** It is an aim of these Principles and Code of Ethical Market Conduct that companies utilize duly qualified, not merely licensed, distributors as a key to providing quality sales practices in the marketplace. Principle 2, Code C attempts to incorporate that concept by requiring that a company's distributors and appropriate company employees are trained in the company policies and procedures, applicable laws and regulations and the Principles and Code of Ethical Market Conduct. To comply with these requirements, training shall include:

- how to analyze customer insurable needs and financial objectives to assist them with making buying decisions about what is appropriate for them;
- the use of fact finding tools for determining customer needs and financial objective;
- complaint handling;
- use and approval of marketing and sales material;
- fair competition guidelines, including those related to disparaging competitors or inappropriate statements regarding competitors;
- replacement policies and procedures, including definitions and when replacement are appropriate;
- licensing and appointment requirements;
- qualifications for potential distributors;
- company product features: benefits, limitations, costs, values, charges and operations;
- preparation and use of sales illustrations;
- updates on changes in the laws and regulations and related changes to company policies and procedures; and
- ethical market conduct practices.

**Code D.** Its captive and independent distributors and appropriate company employees have adequate knowledge of the company's products and their operation.

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Comment: For purposes of Code D, one of a number of means for informing distributors about a company's products and their operation is by providing them with descriptive materials to help them understand a covered product's features.

**Code E.** Its captive and independent distributors and appropriate company employees participate in continuing education.

Comment: Continuing education is part of the NAIFA Code of Ethics and is incorporated here. Participation by a company's distributors in continuing education is part of providing "competent" sales and service to its customers. The provisions of Code E are part of, not in addition to, otherwise applicable continuing education requirements of state law or imposed by other authorities. Continuing education should be provided as appropriate to the company's distribution systems.

**Principle 3:** To engage in active and fair competition.

Comment: Focus on fair competition in the marketplace provides an opportunity to identify certain negative practices that can be targeted for attention, such as inappropriate replacement and competitor "bashing." A company's undertaking to engage in active and fair competition does not necessarily mean that such member is expected to compete in all covered product market segments or with all possible products. A company must be free to compete in limited segments or with limited products according to its own ability to serve its targeted customers and according to its own marketing plans and goals, both financially and in the marketplace.

Companies are committed to competition as the most effective and efficient means of providing products and services to customers. Competition is also the most efficient regulator of activities. To maintain and enhance competition in the marketplace for covered products, a company will develop policies and procedures designed to provide reasonable assurance that:

**Code A.** The company maintains compliance with applicable state and federal laws and regulations fostering fair competition and requires its captive and independent distributors and appropriate company employees to refrain from disparaging competitors.

Comment: Further guidance on "disparaging" conduct for Code A is seen through the Assessment Questionnaire's inquiry to test for the proscription, but the intent here is to allow the use of relevant, factually accurate information to foster vigorous competition. "Disparaging remarks" do not include relevant, factually accurate information.

**Code B.** The company or its captive and independent distributors and appropriate company employees provide information to customers in a manner consistent with Principle 4 prior to replacing covered products.

Comment: Such communication on replacement policies or contracts should include providing the customer with reasons why replacement might not be appropriate.
**Principle 4:** To provide advertising and sales materials that are clear as to purpose and honest and fair as to content.

**Comment:** Current state laws and regulations on advertising, unfair trade practices, and sales illustrations provide a fairly detailed set of public policy requirements for advertising and sales materials. Companies should acknowledge and incorporate those ideas into their development of advertising and sales materials for covered products.

To provide advertising and sales materials which are clear as to purpose and honest and fair as to content, a company will develop policies and procedures designed to provide reasonable assurance that:

**Code A.** Presentation of any material designed to lead to sales or solicitation of covered products is done in a manner consistent with the needs of the customer. All such sales or solicitation communications should be based upon the principles of fair dealing and good faith, and will have a sound basis in fact. Comment: One of the important areas identified for improvement of market conduct is fair disclosure of the product sold to a customer. Code A, among other things, seeks to emphasize accurate disclosure about the product sold. The intent of Code A is to promote upgrading, and making meaningful use of tools, such as a "buyer's guide" and the "cost disclosure" at the point of sale.

**Code B.** Materials presented as part of a sale are comprehensible in light of the complexity of the product being sold.

**Code C.** It maintains compliance with applicable laws and regulations related to advertising, unfair trade practices, sales illustrations, and other similar provisions.

**Code D.** Illustrations or other representations of premiums and considerations, costs, values, and benefits are accurate, fair, and complete and contain appropriate disclosures.

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

**Comment:** The appropriate handling of customer complaints and disputes related to sales and marketing of covered products is an important element of ethical market conduct. State laws and regulations require certain processes. Companies are also encouraged, but not required, by the Principles and Code of Ethical Market Conduct to consider additional methods of resolving complaints and disputes related to sales and marketing practices such as Alternative Dispute Resolution or other alternatives designed to deal with disputes without requiring civil litigation.

The American Arbitration Association or alternate organizations might be sources available to assist companies in establishing ADR processes.

To resolve any complaints and disputes that may arise concerning market conduct, an company will develop policies and procedures designed to provide reasonable assurance that:
**Code A.** Complaints are identified, evaluated, and handled in compliance with applicable laws and regulations related to consumer complaint handling.

**Code B.** Good faith efforts are made to resolve complaints and disputes without resorting to civil litigation.

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

**Comment:** Principle 6 is one of the key components of the Code. It addresses the maintenance of an effective system of compliance supervision.

A critical element in the establishment of an effective market conduct compliance program is management support. Support from the top of an organization is a cornerstone in creating an environment within a company where compliance is an important management objective.

To maintain a system of supervision and review that is reasonably designed to achieve compliance with these Principles and Code of Ethical Market Conduct, a company will develop policies and procedures designed to provide reasonable assurance that:

**Code A.** It establishes and enforces policies and procedures reasonably designed to comply with the Principles and Code of Ethical Market Conduct.

**Code B.** There is an adequate system of supervision of the sales and marketing activities of its distributors and appropriate company employees in order to monitor their compliance with these Principles and Code of Ethical Market Conduct and applicable laws and regulations.

**Comment:** Companies are required to supervise their sales and marketing activities. Responsibility for supervising sales and marketing activities may be assigned to a variety of individuals within the company or may be delegated to independent intermediaries. However, ultimate responsibility to reasonably assure whether supervision has taken place must be borne by the company. Accordingly, in those instances in which the obligations under Principle 6, Codes B, C and D are delegated to independent intermediaries, the company must continue to supervise the performance of those obligations and bears ultimate responsibility for compliance with all other provisions of the Principles and Code of Ethical Market Conduct in the sales and marketing of its covered products.

If a company delegates any supervisory responsibility to an independent intermediary, the company shall enter into a written agreement with such intermediary which specifies the responsibilities delegated. Examples of such responsibilities might include:

1. Responsibility for ascertaining the good character, business repute, and qualifications of the Independent Distributor in accordance with Principle 2, Code A.
2. Adherence to the company's and the independent intermediary's compliance requirements.
3. Restrictions or directions on the use of sales materials related to the company's products.
4. A requirement for prompt reporting to the company of customer or regulatory complaints or inquiries.
5. Maintenance of licenses and books and records according to company standards or required by applicable laws regulations.
6. Training in accordance with Principle 2, Codes C, D, and E, and Principle 6, Code C.
8. Penalties for the breach of the agreement.

A company should monitor whether the independent intermediary is performing according to the terms of the written agreement.

Companies should have a system of supervision in place prior to conducting the independent assessment. The system of supervision should be operational before, during and after the independent assessment and should provide routine information on a periodic basis to allow the company to conduct ongoing supervision. The company must monitor its system of supervision to provide reasonable assurance that it complies with the Principles and Code of Ethical Market Conduct and applicable laws and regulations through testing methods consistent with Principle 6, Code D.

The company’s system of supervision of its sales and marketing activities should reflect the structure, functions and risks of the company and its distribution systems and must include, at a minimum:

- Assignment of responsibility and accountability for reasonably assuring supervision of all distribution systems for covered products;
- Procedures for routinely and systematically supervising compliance and identifying instances of non-compliance with company policies and procedures, the Principles and Code of Ethical Market Conduct and applicable laws and regulations;
- Procedures for responding to identified instances of non-compliance with policies and procedures, the Principles and Code of Ethical Market Conduct and applicable laws, regulations, where appropriate; and
- Means of reasonably assuring that corrective action has been taken, where appropriate.

The provisions of Codes B, C, and D present different challenges to companies based on their size and distribution system. Smaller companies may meet these standards in a variety of ways different from larger companies that may have more resources. Flexibility has been built in to allow companies of all sizes to meet these standards.

**Code C.** Compliance training sessions are conducted for appropriate company employees on the company’s policies and procedures, the Principles and Code of Ethical Market Conduct and applicable laws and regulations.

**Comment:** It is an aim of this Principle and Code that the company conducts compliance training sessions for appropriate company employees on the
company's policies and procedures, the Principles and Code of Ethical Market Conduct and applicable laws and regulations. Principle 6, Code C attempts to incorporate that concept. Company training sessions should include the following topics:

- the Principles and Code of Ethical Market Conduct; policies and procedures developed by the company to implement the Principles and Code of Ethical Market Conduct;
- the company's commitment to the Principles and Code of Ethical Market Conduct requires appropriate company employees to ensure that the company designs, sells and issues products that meet customer insurable needs and financial objectives;
- complaint handling;
- fair competition guidelines, including those related to disparaging competitors or inappropriate statements regarding competitors;
- replacement policies and procedures, including definitions and when replacements are appropriate;
- company product features: benefits, limitations, costs, values, charges and operations;
- updates on changes in the laws and regulations and related changes to company policies and procedures; and
- ethical market conduct practices.

Code D. It establishes and enforces policies and procedures reasonably designed to monitor compliance with the Principles and Code of Ethical Market Conduct and applicable laws and regulations.

Comment: Companies are required to have a monitoring system to reasonably assure that the sales and marketing practices of its captive and independent distributors and appropriate company employees comply with the Principles and Code of Ethical Market Conduct and applicable laws and regulations. Similar to the supervision requirements under Principle 6, Code B, responsibility for monitoring sales and marketing activities may be assigned to a variety of individuals within the company or may be delegated to independent intermediaries. Ultimate responsibility to verify whether monitoring has taken place must be borne by the company. The company should review its monitoring system to reasonably assure it is operating properly and providing relevant, accurate data. Accordingly, in those instances in which the obligations are delegated to independent intermediaries, the company must continue to monitor the performance of those obligations.

Companies must have a monitoring system as a minimum standard that reasonably assures compliance with Principle 6, Code D. The monitoring system should include elements that will permit the company to review its home office and field sales and marketing practices to determine whether they are consistent with the company's policies and procedures, the Principles and Code of Ethical Market Conduct.
Market Conduct, and applicable laws and regulations. Companies and Independent Assessors may employ a variety of testing methods to provide reasonable assurance that compliance monitoring activities provide meaningful information regarding the company’s sales practices that is used to take corrective action, if warranted, at the home office and field distribution levels.

Companies may fulfill Code D requirements through various means, including, but not limited to, internal auditing, telephonic or written surveys of captive or independent distributors or appropriate company employees, LIMRA CAP surveys or other customer surveys, complaint analysis and information, lapse trends, replacement activity reports, customer transaction histories (surrenders, withdrawals, not-takens), underwriting exception reports, lists or numbers of rejected field advertising pieces submitted for home office review and approval, disciplinary records, etc.

A company must also reasonably assure that corrective action has been taken, where appropriate by: performing on-site office inspections, interviewing customers or captive or independent distributors or appropriate company employees, surveying customers or captive and independent distributors or appropriate company employees, using "mystery shoppers," or other means. On-site office inspections may be appropriate for distribution systems where trends are identified through exception reports or other monitoring tools. The company should conduct any field validation at the appropriate level of the distribution system. For example, as part of a routine audit or field visitation program, the company may interview the head of the distribution channel and then select a sample of supervisors; however, issues may arise through the monitoring procedures that will require field validation at the writing agent level.