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MY CUSTOMER'S KEEPER: THE SEARCH FOR A UNIVERSAL SUITABILITY STANDARD IN THE SALE OF LIFE INSURANCE

RICHARD J. WIRTH*

INTRODUCTION

As consumers, we depend on producers¹ to guide us through a maze of complex financial products.² We trust them to help us make the right decisions for ourselves now and for our loved ones after we are gone. We rely on them to recommend products that are suitable for us and to make us whole when those products fail to meet our expectations. A producer's obligation to meet this challenge varies based on a hodgepodge of sometimes inconsistent, overlapping rules and practices. These vary depending on the state, type of product, and type of producer. For example, we may receive one type of suitability advice³ from a producer sitting in his office, but different advice from the same person when he is sitting in a local bank branch or an office in the next state. The advice may also vary if it is doled out by cyber agents on the Internet, television "experts," lawyers, accountants, or even "do it yourself"

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1. For the purposes of this Article, a "producer" shall refer to any form of agent or representative engaged, appointed, or designated by an insurance company (referred to herein as a "manufacturer") in connection with the sale and solicitation of "products." Producers may sometimes be categorized as "career agents" (producers who distribute products primarily for a single manufacturer) and "brokers" (producers appointed by many different manufacturers to distribute their products). These terms may vary from manufacturer to manufacturer and do not include hybrid relationships between producers and manufacturers such as person producing general agents (PPGAs).

2. As used herein, a "product" refers to the life insurance policies or annuity contracts issued by a manufacturer.

3. "Suitability advice" refers to advice given by a producer as to which products suit a particular client's needs.

financial software programs. The lack of consistency among suitability standards confuses and scares most of us. It also causes trepidation in producers and manufacturers as "suitability" has evolved into an after-the-fact way for consumers to hold them responsible for the consequences of unfavorable investment experiences.

Congress may have envisioned a universal suitability standard when it enacted landmark financial modernization legislation.⁴ However, insurance regulators and the insurance industry have thus far resisted development of a standard that could be used by all producers. The directive to develop a universal suitability standard, along with the emergence of new types of producers who are better equipped to compete in the absence of such a standard, provides a strong impetus for the financial services industry⁵ to either rally behind a common benchmark or to have one forced upon them.

Developing a consensus for a universal standard is no easy task. Resistance to it is fueled, in part, by disagreements about how or whether such a standard should consider investment outcomes or be based on a defined and replicable process. Other considerations involve fundamental questions about the standard of care to which we should hold producers and whether we should hold customers to different standards based on their investment acumen. Ultimately, the answers to these questions will have a significant impact on the way that products are recommended and the way we view our producers and manufacturers.

Part I of this Article discusses various approaches to suitability developed in connection with the sale of traditional and variable products.⁶ Part II briefly explores some of the ways producers have been held legally accountable for the outcome of "unsuitable" sales. Part III explores different approaches to developing an appropriate universal standard.

4. Gramm-Leach-Bliley Act, Pub. L. 106-102, 113 Stat. 1338 (1999).

5. For the purposes hereof, the "financial services industry" refers to the business sector involved in the sale and solicitation of life insurance, annuities, and the provision of associated investment advice.

6. As used herein, the term "traditional products" refers to life insurance and annuities in which policy owners or annuitants, as the case may be, do not share in the investment experience associated with their premiums. Examples of traditional policies include whole life insurance or fixed annuities. "Variable products" shall refer to life insurance policies or annuities that constitute securities within the meaning of the Securities Act of 1933, as amended, inasmuch as policy owners and annuitants may designate portions of their premiums to be invested in some form of underlying investment. Examples of variable products include variable universal life insurance or variable annuities.

I. THE VARIOUS APPROACHES TO SUITABILITY

The word "suitability" has come to mean different things to consumers, producers, and regulators. To some it means the process of exploring investment-related risks based on a customer's financial sophistication and then recommending suitable products for that consumer. To others, any type of suitability analysis is acceptable as long as producers are guided by ethical concepts such as fair dealing and the provision of clear disclosures. Still others feel that each solicitation experience is unique and, therefore, no one standard should exist. While each of these arguments has its appeal, regulators have developed various suitability standards to address differences among customers, types of producers, solicitation sites, and types of products.

A. Customer Specific Suitability

1. The NASD Non-"Sophisticated" Securities Investor Suitability Rule

According to the National Association of Securities Dealers ("NASD"), "suitability" for the non-"sophisticated" variable product customer largely involves recommending investments based on the customer's particular investor profile and appreciation of "risk."⁷ The first step in this process is for producers to "know" their customers.⁸ This entails conducting a study of their customer's financial situation, preferences, and risk tolerance.⁹ "Fact

7. Recommendations to Customers (Suitability), NASD Conduct Rule 2310(a), NASD Manual & Notices to Members (1998), available at <http://secure.nasdr.com/wbs/NETbos.dll?Refshow?ref=NASD4;&xinfo=/goodbye.htm>.

8. *Id.*; see also N.Y.S.E. Rule 405(1), 2 N.Y.S.E. Guide (CCH) ¶ 2405, at 3696 (Aug. 1994).

9. See Direct Participation Programs: Suitability, NASD Conduct Rule 2810(b)(2), NASD Manual & Notices to Members (1998), available at <http://secure.nasdr.com/wbs/NETbos.dll?Refshow?ref=NASD4;&xinfo=/goodbye.htm>; Distribution of Securities of Members & Affiliates-Conflicts of Interest: Suitability, NASD Conduct Rule 2720(k), NASD Manual & Notices to Members (1998), available at <http://secure.nasdr.com/wbs/NETbos.dll?Refshow?ref=NASD4;&xinfo=/goodbye.htm>; NASAA Omnibus Guidelines, NASAA Rep. (CCH) ¶ 2323, at 1388 (Oct. 1983); N.Y.S.E. Rule 405(1), *supra* note 8; OCC Advisory Letter 96-8, ¶ D(3), at 10 (Oct. 8, 1996), available at <http://www.occ.ustreas.gov/ftp/advisory/96-8.htm>; Options: Suitability, NASD Conduct Rule 2860(b)(19), NASD Manual & Notices to Members (1998), available at

<http://secure.nasdr.com/wbs/NETbos.dll?Refshow?ref=NASD4;&xinfo=/goodbye.htm>; Policy Statement on *Dishonest or Unethical Business Practices*, NASAA Rep. (CCH) ¶ 1402, at 901 (Aug. 1997); Recommendations to Customers (Suitability), *supra* note 7; SIB Conduct of Business Rule § 3.01, PIA RULE BOOK 17 (May 1995) (U.K. "know

finders” or client data sheets are common methods producers use to acquire this information. A “fact finder” is a questionnaire used to elicit an array of personal information about a customer.¹⁰ This information may include the following:¹¹

your customer” rule); Special Products: Suitability, NASD Conduct Rule 2844, NASD Manual & Notices to Members (1998), *available at* <http://secure.nasdr.com/wbs/NETbos.dll?Refshow?ref=NASD4;&xinfo=/goodbye.htm>; Unethical Business Practices of Investment Advisors § 1, Statement of Policy adopted by North American Securities Administrators Ass’n, Inc. (Apr. 5, 1985), NASAA Rep. (CCH) ¶ 2201, at 1301 (1986). *See generally* Unif. Commercial Code § 1-203, 1 U.L.A. 109 (West Supp. 1999) (good faith performance of all contracts); *id.* § 2-315 (implied warranty of fitness for a particular purpose); Robert H. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 452 (1965) (describing the suitability standard as a “first-cousin” to the Uniform Commercial Code implied warranty of fitness for a particular purpose). For general articles discussing the history of securities suitability rules, see Seth C. Anderson & Donald Arthur Winslow, *Defining Suitability*, 81 KY. L.J. 105 (1992); Richard A. Booth, *The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk*, 54 BUS. LAW. 1599 (1999); Constantine N. Katsoris, *SICA: The First Twenty Years*, 23 FORDHAM URB. L.J. 483 (1996); Janet E. Kerr, *Suitability Standards: A New Look at Economic Theory and Current SEC Disclosure Policy*, 16 PAC. L.J. 805 (1985); Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557 (1999); F. Harris Nichols, *The Broker’s Duty to His Customer Under Evolving Federal Fiduciary and Suitability Standards*, 26 BUFFALO L. REV. 435 (1977); Robert N. Rapp, *Rethinking Risky Investments for That Little Old Lady: A Realistic Role for Modern Portfolio Theory in Assessing Suitability Obligations of Stockbrokers*, 24 OHIO N.U. L. REV. 189 (1998).

10. NASD Conduct Rule 2310(a) indicates that suitability is based on “the facts, if any, disclosed by [the] customer as to his other security holdings and as to his financial situation and needs.” Recommendations to Customers (Suitability), *supra* note 7; *see also* Customer Account Information, NASD Conduct Rule IM-3110(b), NASD Manual & Notices to Members (1998), *available at* <http://secure.nasdr.com/wbs/NETbos.dll?RefShow?ref=NASD4;&xinfo=/goodbye.htm>; The NASD Reminds Members of Their Responsibilities Regarding the Sale of Variable Life Insurance, NASD Notice to Members 00-44, June 16, 2000, 2000 WL 1375112 (National/Federal) [hereinafter NTM 00-44]; Standards Applicable to Communications with the Public, NASD Conduct Rule 2210(d)(2)(B)(ii), NASD Manual & Notices to Members (1998), *available at* <http://secure.nasdr.com/wbs/NETbos.dll?RefShow?ref=NASD4;&xinfo=/goodbye.htm>; Suitability Obligations to Institutional Customers, NASD Conduct Rule IM-2310-3, NASD Manual & Notices to Members (1998), *available at* <http://secure.nasdr.com/wbs/NETbos.dll?RefShow?ref=NASD4;&xinfo=/goodbye.htm>.

11. *See* Recommendations to Customers (Suitability), NASD Conduct Rule 2310(b), NASD Manual & Notices to Members (1998), *available at* <http://secure.nasdr.com/wbs/NETbos.dll?RefShow?ref=NASD4;&xinfo=/goodbye.htm>; *see also* Fair Dealing with Customers, NASD Conduct Rule IM-2310-2(b)(5), NASD Manual & Notices to Members (1998), *available at* <http://secure.nasdr.com/wbs/NETbos.dll?RefShow?ref=NASD4;&xinfo=/goodbye.htm>; The NASD Reminds Members of Their Responsibility Regarding the Sale of Variable Annuities; Notice to Members 99-35 (May 1999), 1999 WL 33176256 (National/Federal) [hereinafter NTM 99-35]; NTM 00-44, *supra* note 10; Online Suitability: Suitability Rule and Online Communications, NASD Notice to Members 01-23, at 5 n.7 (Apr.

- Personal information (occupation, marital status, age,¹² number of dependents, investment objectives, risk tolerance,¹³ tax status, investment experience, liquid net worth, other investments and savings, and annual income¹⁴);
- Liquid and illiquid assets (income, cash and equivalents, real and personal property, intangibles, etc.);
- Fixed and variable liabilities (personal and business indebtedness, financial responsibilities, etc.);
- Investments inventory (stocks, bonds, mutual funds, annuities, etc.); and,

2001), available at <http://members.nasdr.com/pdf-text/0123ntm.txt> [hereinafter NTM 01-23]; Standards Applicable to Communications with the Public, *supra* note 10. See generally *In re Greenberg*, 40 S.E.C. 133, 138 (1960) (stating that a broker-dealer must attempt to become familiar with the customer "so as to be in a position to judge the suitability of the recommendation").

12. Customer age is a significant factor, in addition to investment sophistication, in assessing suitability; particularly where speculative investments or churning is involved. See NTM 00-44, *supra* note 10 (overage monitoring); *In re Lewis*, 50 S.E.C. 747, 749 & n.11 (1991) (finding that frequent margin and options trading involving an 82 year-old wealthy widow violates suitability requirements as well as "the fundamental responsibility for fair dealing' implicit in the relationship between a broker and his or her customers") (citing Fair Dealing with Customers, *supra* note 11). See generally UTAH CODE ANN. § 31A-23-303 (1999) (authorizing the insurance commissioner to determine that certain types of disability insurance, life insurance, or annuity products are "inherently unsuitable" for persons of certain ages and any subsequent sale to such persons must be accompanied by a signed disclosure statement); *Estate of Wheaton v. Metropolitan Life Ins. Co.*, 463 N.Y.S.2d 727, 728 (Sup. Ct. 1983) (finding that an 80 year-old in poor health "might very well have reasonably" interpreted a producer's statement as to suitability of an immediate annuity to be factual and not an expression of opinion); COMPTROLLER'S HANDBOOK FOR NAT'L BANK EXAM'RS, § 413.1, O.C.C. Bull. 94-13 (1994) (temp. insert):

One example of a critical suitability determination involves sales to elderly bank customers. Many of these customers rely upon investments or savings for retirement income and may consequently demand high yields. They may not, however, have the ability to absorb or recover losses. A nondeposit investment person should also be aware that it is especially important to make a careful suitability recommendation when dealing with a surviving spouse who is not experienced in investment matters.

Id.; see also *id.* § 413.4 (listing the suitability questions used for compliance monitoring).

13. Risk tolerance refers to a customer's express willingness to assume different levels of investment risk in exchange for possible returns. For instance, someone who would prefer not to lose money investing generally would be considered to have a low risk tolerance. Alternatively, someone who would be willing to take a chance of losing an investment for the opportunity to make a lot more money would be considered to have a high-risk tolerance.

14. NTM 99-35, *supra* note 11; see also Exchange Act Release No. 8,135, [1966-1967 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,459, at 82,890 (Aug. 9, 1967); N.Y.S.E. Rule 721(b), 2 N.Y.S.E. Guide (CCH) ¶ 2721.10, at 4558 (Dec. 1995) (requiring members to exercise due diligence in ascertaining facts about their customers).

- Documentation inventory (wills, trusts, etc.).

The next step in this form of suitability analysis is to assess potential investment strategies to find products that are consistent with the customer's general risk tolerance and investment horizon.¹⁵ To develop an understanding of a customer's risk tolerance, producers may evaluate current holdings. Such an examination will enable the producer to probe a customer's awareness of the different types of investment risks (such as market, inflation, liquidity, interest rate, currency, and lost opportunity risks). Producers may also try to gauge the customer's sophistication about economic trends affecting the relevant securities markets under consideration. Part of this process may also entail developing a sense of whether the customer has the mental and fiscal constitution to withstand financial losses or market fluctuations, for even the best planned investment strategy will be of no value to a customer who is incapable of stomaching market downturns.¹⁶ Curiously, despite these common concerns and techniques, there is no quantum of information, or data gathering device, that all producers use to assess consumer risk tolerances reliably and consistently.

15. The term "investment horizon" is used to refer to the relative point in time when the customer is likely to want to recoup his investment. For example, a person saving for a newborn's college education would have an approximately sixteen-year investment horizon.

16. See MICHAEL J. ROSZKOWSKI, *RISK-TOLERANCE IN FINANCIAL DECISIONS, FUNDAMENTALS OF FINANCIAL PLANNING* 57-99 (2d ed. 1993). This propensity to underestimate risk could be a possible basis for misrepresentations. See generally CONSUMER RESEARCH UNIT, LIMRA INT'L, INC., *DIRECT RESPONSE: BUYING LIFE INSURANCE THROUGH BANKS AND S&LS* 35 (Judith R. Kulak ed. 1999) [hereinafter *DIRECT RESPONSE*] (noting that a significant number of bank customers acknowledge that they did not really understand what policy they had purchased); Adopted SIB Rule S3.03(2), *PIA RULE BOOK*, (June 1998) (stating that U.K. customers must understand the risk inherent in recommended investments); Booth, *supra* note 9, at 1605 (advocating that producers who cause customers to assume unnecessary risk should be liable under well-established principles of fiduciary duty); Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 *BUS. LAW.* 429 (1998) (examining the extent to which management owes a fiduciary duty to stockholders and the stockholders' right to sue for breach); Howell E. Jackson, *Regulation in a Multisector Financial Services Industry: An Exploratory Essay*, 77 *WASH. U. L.Q.* 319, 345, 349, 356-67 (1999) (explaining that while informed consent may relieve a regulated party from some disclosure-oriented duties, disclosure strategies are not entirely effective in helping public investors to process information about risk and the multi-faceted nature of insurance); Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 *U. PA. L. REV.* 851, 858-72 (1992) (discussing the rationality of investor behavior); Lynn A. Stout, *Are Stock Markets Costly Casinos?*, 81 *VA. L. REV.* 611 (1995) (suggesting a heterogeneous expectations model for predicting investor expectations ex ante and avoiding ex post disappointment).

Recommendation of a particular product also varies depending on the consumer's anticipated investment horizon and financial resources. For instance, consumers may be attracted to different products depending on how long they expect to live. Similarly, a consumer's current financial resources may dictate whether she elects to purchase more or less insurance. Taken together, a producer might recommend that a young person, who expects to live a long life and has little disposable income at the time of solicitation, buy only as much insurance as is necessary for her burial. On the other hand, a producer might recommend that a 40-year-old person, who has a great deal of disposable income at the time of solicitation, buy enough insurance to sustain her family in the lifestyle to which they have become accustomed, pay for her children's college education, and perhaps leave some remaining proceeds for her favorite charity.

The suitability analysis process culminates with a "recommendation." A recommendation should be supported by the producer's development of a reasonable basis to believe that it is suitable for that specific customer¹⁷ "or at least *some* customers."¹⁸ The exact form of communications that constitute a recommendation varies depending upon the facts and circumstances.¹⁹ The determination of how or whether a "recommendation" was made is critical because producers who act as mere order-takers for their customers' unsolicited orders are exempt from the obligation to perform a suitability analysis.²⁰

17. NTM 01-23, *supra* note 11, at n.3 (discussing relevancy to "more traditional communications, such as discussions in person, over the telephone, or through postal mail").

18. *Id.* at n.4. While suitability should preferably be based on the instant consumer's preference and needs, the NASD acknowledges that a producer could defend the suitability of a recommendation if the recommendation would be suitable for other consumers with a similar risk profile. *Id.*

19. *Id.* at 3.

20. See Exchange Act Release No. 34-30,608, 57 Fed. Reg. 18,017 (Apr. 28, 1992) (stating that a broker-dealer has not made a recommendation when it acts solely as an order taker); NTM 01-23, *supra* note 11, at n.7; Clarification of Notice to Members 96-60, Mar. 1997, 1997 WL 1909772 (National/Federal) (stating that events or circumstances constituting a recommendation "depend on an analysis of all the relevant facts and circumstances"); see also Exchange Act Release No. 8,135 [1966-1967 Transfer Binder], *supra* note 14, at 82,890 (commenting that mass mailings of research report to all customers should not constitute a recommendation). *But see* Exchange Act Rule 15g-9m, 17 C.F.R. § 240.15g-9(b) (1999) (penny stock suitability rules); Members Reminded to Use Best Practices When Dealing in Speculative Securities, NASD Notice to Members 96-32, May 9, 1996, 1996 WL 1771312 (National/Federal) [hereinafter NTM 96-32] (stating that suitability requirements do not vary as to whether the sale was solic-

2. The Sophisticated Securities Customer

“Sophisticated” and institutional securities investors are subject to different suitability standards than the average investor described above.²¹ Consistent with other securities laws, NASD Conduct Rules arguably establish lower suitability obligations for affluent or astute securities investors.²² Regardless of these thresh-

ited or not solicited when involving low-price, speculative securities). With few exceptions, such as term life insurance, it could be argued that most life products are “sold” rather than “bought,” thereby eliminating a producer’s opportunity to avoid suitability obligations. See *DIRECT RESPONSE*, *supra* note 16, at 29; see also *Sales Practice Requirements for Certain Low- Priced Securities*, Exchange Act Release No. 27,160 [1989 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 84,440, at 80,416 (Aug. 22, 1989) (penny stocks).

21. Some types of investors included in this group are financial institutions, trusts with total assets in excess of \$5 million, and affluent investors. Securities Act of 1933, 17 C.F.R. § 230.501(a) (1992) (defining “accredited investors” to include (a) person whose individual net worth, or joint net worth with that person’s spouse, at the time of purchase exceeds \$1 million or (b) person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a “reasonable expectation” of reaching the same income level in the current year); Investment Advisers Act of 1940, 17 C.F.R. § 275.205(a) (1992) (permitting performance based advisory contracts with “qualified clients”); 17 C.F.R. § 275.205-3(d)(1) (defining “qualified clients” to include, among other things, (i) persons who have at least \$750,000 under management with the investment adviser; or (ii) a person or company that has a net worth, individually or with a spouse, of more than \$1.5 million at the time of contract); Investment Company Act of 1940, 15 U.S.C.A. § 80a-3(c)(7)(A) (West 1997) (exempting non-publicly traded entities comprised of “qualified purchasers” from the definition of an investment company). “Qualified purchasers” generally include (i) people or companies who own not less than \$5 million in investments; (ii) trusts whose trustees consist of qualified purchasers; and (iii) any person, acting for his own behalf or other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than \$25 million in investments. Investment Company Act of 1940, 15 U.S.C.A. § 80a-2(a)(51)(A) (West 1997).

22. See *Suitability Obligations to Institutional Customers*, *supra* note 10 (noting that while the suitability guidelines applicable to institutional customers adopted in 1996 are “difficult to determine in advance,” they continue to be “customer-specific”); see also *Bruschi v. Brown*, 876 F.2d 1526, 1529 (11th Cir. 1989) (listing the plaintiff’s sophistication and expertise in financial and securities matters as a factor in assessing the reasonableness of a plaintiff’s reliance); *Lieb v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953 (E.D. Mich. 1978), *aff’d*, 647 F.2d 165 (6th Cir. 1981) (stating that the manner in which a broker carries out his duties depends on the customer’s intelligence and personality); *cf.* *Myers v. Finkle*, 950 F.2d 165, 168 (4th Cir. 1991) (stating that criteria other than wealth, such as age, education, professional status, investment experience, and business background, may be relevant in assessing sophistication); *Komanoff v. Mabon, Nugent & Co.*, 884 F. Supp. 848, 854 n.3 (S.D.N.Y. 1995) (stating that business sophistication of customer is irrelevant in the context of a statute of limitations challenge). *But see Hanly v. SEC.*, 415 F.2d 589, 596 (2d Cir. 1969) (holding that a salesperson’s due diligence obligations relative to recommended securities are not affected by customer sophistication); *NASD Issues Rule Proposal on Members’ Suitability Obligations*, 27 Sec. Reg. & L. Rep. (BNA) No. 16, at 594 (Apr. 21, 1995)

olds, a producer, who is also a registered representative,²³ continues to be expected to meet "high standards of competence, professionalism, and good faith."²⁴ The NASD has identified two important considerations in determining the suitability of a recommendation to a sophisticated customer.²⁵ The first factor is the customer's ability to independently evaluate investment risk.²⁶ NASD Conduct Rule IM-2310-3 provides the following guidance in assessing independent risk assessment:

A member must determine, based on the information available to it, the customer's capability to evaluate investment risk. In some cases, the member may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk If a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product, the scope of a member's customer-specific obligations under the suitability rule would not be diminished by the fact that the member was dealing with an institutional customer. On the other hand, the fact that a customer initially needed help understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent investment

(offering guidance to members on how to determine when their obligations to institutional investors have been met, but cautioning that the proposed rule did not provide a "safe harbor"). See generally Willa E. Gibson, *Investors, Look Before You Leap: The Suitability Doctrine Is Not Suitable for OTC Derivatives Dealers*, 29 LOY. U. CHI. L.J. 527, 546-65 (1998) (discussing the impact of suitability standards on institutional investors in the aftermath of derivatives investments gone awry); Rapp, *supra* note 9, at 232-35 (examining cases involving sophisticated customers).

23. In securities sales, the term "registered representative" refers to any producer who is associated with a broker-dealer that is a member of the NASD.

24. Suitability Obligations to Institutional Customers, *supra* note 10; see also Fair Dealing with Customers, *supra* note 11. Even though the registered representative may rely on customer statements in connection with its suitability analysis, Recommendations to Customers (Suitability), *supra* note 7, the potential repercussions for an incorrect conclusion may justify independent verification. The SEC has consistently looked to whether customers, especially wealthy older customers who were new to investing, fully understood and accepted investment risks. See, e.g., *In re Dambro*, 51 S.E.C. 513, 517 (1993) (stating that the appropriateness of a transaction is based on the particular investor and not whether the individual can afford to lose the money invested); *In re Erdos*, 47 S.E.C. 985, 989 (1983) (finding that excessive trading in the account of an elderly widow of limited financial means violated suitability standards); *In re Philips & Co.*, 37 S.E.C. 66, 70 (1956) (stating that recommendations must be consistent with a customer's financial situation and needs).

25. Suitability Obligations to Institutional Customers, *supra* note 10.

26. *Id.*

decision.²⁷

The second "most important" factor is the customer's ability to exercise independent judgment in evaluating the representative's recommendations.²⁸ The following statement summarizes the application of these prerequisites:

A member may conclude that a customer is exercising independent judgment if the customer's investment decision will be based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations. Where the broker-dealer has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk, then a member's obligation to determine that a recommendation is suitable for a particular customer is fulfilled. Where a customer has delegated decision-making authority to an agent, such as an investment advisor or a bank trust department, this interpretation shall be applied to the agent.²⁹

The NASD also lists various "resources" and considerations³⁰ for whether a customer *could* be making independent investment decisions. Clearly, these factors indicate a lesser sense of paternalism toward these investors as compared to the average customer.

B. *Product Specific Suitability Standards*

The following discussion illustrates that in addition to customer-specific suitability standards, the type of suitability analysis provided could vary based on the type of product recommended. Suitability standards for traditional products³¹ differ from those applied to variable products.³² One explanation for this difference could be that most insurance regulators have yet to embrace any suitability standard while self-regulatory organizations, such as the NASD, have had enduring standards that have been publicly enforced.³³ Another reason could be that the paternalistic approach

27. *Id.* (According to NASD parlance, the word "member" refers to any broker-dealer that maintains membership with the NASD.).

28. Suitability Obligations to Institutional Customers, *supra* note 10.

29. *Id.*

30. *Id.*

31. See *supra* note 6 for a definition of traditional products.

32. See *supra* note 6 for a definition of variable products.

33. See *In re Holland*, 52 S.E.C. 562 (1995); *In re Keel*, 51 S.E.C. 282, 283 & 286 (1993) (determining that a customer's failure to complain that transactions were unau-

taken by state insurance regulations contrasts with the disclosure orientation of securities laws.³⁴ The differences between approaches by insurance regulators, on one hand, and securities and banking regulators, on the other, may soon become more blurred as a result of the Gramm-Leach-Bliley Act³⁵ and numerous attempts by entities such as the NASD and Securities and Exchange Commission ("SEC") to extrapolate their standards onto insurance related products.³⁶

thorized does not relieve a broker of the obligation to meet suitability standards); *In re Wickswat*, 50 S.E.C. 785, 787 (1991) (stating that registered representatives must make recommendations consistent with the customer's objectives and needs regardless of whether the customer acquiesces in the particular strategy); *In re F.J. Kaufman & Co.*, 50 S.E.C. 164 (1989) (stating that registered representatives have a duty to recommend and sell products that were consistent with the customer's specific investment needs and objectives); NAT'L ASS'N OF SECS. DEALERS, INC., NASD SANCTION GUIDELINES 91-92 (2001), available at <http://www.nasdr.com/3100.asp> (recommending various penalties for egregious violations of sales practices, including suspension or bar of the registered representative or broker, fines of up to \$100,000, rescission, and restitution); Carl B. Wilkerson, A New Regulatory Paradigm: Variable Product Distribution And Compliance, Address to the 1998 ACLI Compliance Section Annual Meeting (July 15, 1998) (monitoring of suitability of initial sales and sub-account investments has become an indication of good internal controls and sales practices) (on file with author).

34. It may be argued that the NASD's approach to suitability allows a consumer to make an investment decision once the producer provides all relevant information. On the other hand, insurance regulators tend to over-protect consumers by considering factors such as the consumer's wherewithal to appreciate the nature of the disclosures provided. See *supra* Part I for a discussion of different approaches to determining suitability.

35. Gramm-Leach-Bliley Act, Pub. L. 106-102, 113 Stat. 1338 (1999).

36. See Rules Relating to Over-the-Counter Markets, 17 C.F.R. § 240.15c2-5 (1999) (involving suitability of equity funding programs in which mutual fund shares are pledged as collateral for loans used to fund insurance premiums); Application of NASD Conduct Rules to Group Variable Contracts and Other Exempted Securities, NASD Notice to Members No. 97-27, May 1997, 1997 WL 1909794 (National/Federal); NASD Regulation Reminds Members and Associated Persons That Sales of Variable Contracts Are Subject to NASD Suitability Requirements, NASD Notice to Members No. 96-86, Dec. 1996, 1996 WL 1771346 (National/Federal) [hereinafter NTM 96-86]; NASD Files with the SEC Proposed Rule Governing Members Operating on Bank Premises, NASD Notice to Members No. 96-3, Jan. 1996, 1996 WL 1771293 (National/Federal).

Variable insurance products, it is said, are "kitchen table" products, because they're sold to aging baby boomers, perhaps along with other insurance products like life, home or auto insurance, in conversations at the consumer's kitchen table. These consumers may be first time annuity buyers who may not have the financial background or experience to readily understand the risks of investing. Many have never seen a down market. Couple this fact with the complexity of the variable annuity product itself, and the fact that many consumers may not realize the variable annuity is an investment that can decrease in value, and you have the potential for problems.

Lori A. Richards, Good Compliance: A Small Price to Pay for the Enormous Growth in Variable Annuities, Address to the National Association for Variable Annuities (June 30, 1997) (transcript on file with author); see also *Dist. Bus. Conduct Comm. v. Cruz*,

1. Traditional Products

Very few states have a suitability standard applicable to traditional products. For those states that do have a standard, the words used to regulate this process range from “suitable,”³⁷ “not unsuitable,”³⁸ to “inherently unsuitable.”³⁹ More states are not likely to adopt a suitability standard that addresses both traditional and vari-

No. C8A930048, 1997 WL 33101218, at *2 (Nat'l Bus. Conduct Comm. Oct. 31, 1997) (applying NASD rules to a flexible premium variable life insurance product). For a discussion of various regulatory excursions, see Jackson, *supra* note 16, at 379-87.

37. See MINN. STAT. ANN. § 60k.14 subd. 4 (West 1996 & Supp. 2000); MINN. STAT. ANN. § 72A.20 subd. 34 (West Supp. 2002); N.D. ADMIN. CODE § 45-02-02-14(2)(1998); see also LIFE INS. DISCLOSURE MODEL REG. §2(A), III NAIC Model Reg. Serv. 580-1 (Nat'l Ass'n Ins. Comm'rs, Inc.) (Oct. 2000). But see KAN. ADMIN. REGS. § 40-2-14(c)(5). The sporadic adoption of a traditional insurance suitability standard contrasts with the vast adoption of such standards for variable life insurance and states that have adopted securities suitability requirements for prohibited unethical and dishonest practices in their blue sky laws. See VARIABLE LIFE INS. MODEL REG., at 270-32 to -33. Several states have adopted a securities suitability requirement. See ALA. ADMIN. CODE § 830-X-3.21(1)(a), 1 Blue Sky L. Rep. (CCH) ¶ 7436B, at 3416 (Sept. 1999); CONN. AGENCIES REGS. §§ 36b-31-15a(a)(2) & 15c(a)(2) (1998) (advisors); FLA. ADMIN. CODE ANN. r. 3E-600.013(1)(d), 1A Blue Sky L. Rep. (CCH) ¶ 17,463A, at 13,431 (Apr. 2001); IDA. BLUE SKY REG. r. 188, 1A Blue Sky L. Rep. (CCH) ¶ 21,411H, at 17,411 (Nov. 2001) (unsuitable recommendations); IND. ADMIN. CODE § 1-16-22(a)(1), 2 Blue Sky L. Rep. (CCH) ¶ 24,613M, at 19,475-17 (July 1999); IOWA CODE § 502.404, 2 Blue Sky L. Rep. (CCH) ¶ 25,144, at 20,130 (June 2001); KY. REV. STAT. ANN. § 10:040(2)(5), 2 Blue Sky L. Rep. (CCH) ¶ 27,404, at 22,403-3 (Nov. 2000); MD. BLUE SKY REG. R. .03(B)(1), 2 Blue Sky L. Rep. (CCH) ¶ 30,453, at 25,429 (Mar. 2002); MONT. ADMIN. R. 6.10.126(c), 2A Blue Sky L. Rep. (CCH) ¶ 36,467, at 31,515 (Dec. 2001); NEB. DEP'T BANKING & FIN., tit. 48 r. 002.15, 2A Blue Sky L. Rep. (CCH) ¶ 37,412, at 32,526 (Dec. 2001) (inappropriate investments); NEV. ADMIN. CODE. ch. 90 § 328(h), 2A Blue Sky L. Rep. (CCH) ¶ 36,436B, at 33,505 (Mar. 1998) (over-the-counter securities); N.M. ADMIN. CODE. tit.12, § 11.4.5, 2A Blue Sky L. Rep. (CCH) ¶ 41,538, at 36,415 (May 2001); 18 N.C. ADMIN. CODE. tit. 18 r. 6.1414(b)(3), 2A Blue Sky L. Rep. (CCH) ¶ 43,458, at 38,524 (Dec. 2000); N.D. SEC. COMM'R REG. § 73-02-09-02(3), 3 Blue Sky L. Rep. (CCH) ¶ 44,462, at 39,506 (May 2001); OHIO ADMIN. CODE 1301:6-3-19(A)(5), 3 Blue Sky L. Rep. (CCH) ¶ 45,540, at 40,529-13 (Dec. 1999); OKLA. BLUE SKY REG. § 660:10-5-42(b)(2), 3 Blue Sky L. Rep. (CCH) ¶ 46,472, at 41,527 (Aug. 1998); TEX. ADMIN. CODE § 117.3, 3 Blue Sky L. Rep. (CCH) ¶ 55,603, at 49,568-70 (Jan. 1999) (real estate programs); VA. ADMIN. CODE § 5-20-280(A)(3), 3A Blue Sky L. Rep. (CCH) ¶ 60,426, at 53,517 (July 2001); WASH. ADMIN. CODE. § 460-22B-090(7), 3A Blue Sky L. Rep. (CCH) ¶ 61,618H, at 54,526-27 (Apr. 2000); WIS. ADMIN. CODE § 5.06(4), 3A Blue Sky L. Rep. (CCH) ¶ 64,586, at 56,547 (Jan. 2002); WYO. BLUE SKY REG. ch. 4, § 6(c), 3A Blue Sky L. Rep. (CCH) ¶ 66,425A, at 57,506 (Aug. 1997).

38. See, e.g., IOWA CODE § 191-15.8(4) (1998); VARIABLE LIFE INS. MODEL REG. § 3(C), at 270-74.

39. See, e.g., UT. CODE ANN. § 31A-23-303 (2000) (stating that inherently unsuitable sales are voidable); VT. STAT. ANN. tit. 8, § 4724(16) (1997) (stating that an unfair or deceptive practice includes “soliciting, selling or issuing an insurance policy when the person soliciting, selling, or issuing the policy has reason to know or should have reason to know that it is unsuitable for the person purchasing it”).

able products as the insurance industry and its regulators have not been eager to embrace a securities oriented suitability standard.⁴⁰ Beyond concerns of second-guessing by customers, competitors and the plaintiffs' bar,⁴¹ it has been argued that the fundamental nature of traditional products defies direct comparison with securities suitability standards.⁴² In fact, the New York Insurance Department

40. N.Y. INS. DEP'T, REPORT ON SUITABILITY 2 (1998).

[I]t should be recognized that the underlying premises of a suitability requirement are that (1) life insurance and annuity products have become increasingly complex financial instruments, and (2) many consumers are not sufficiently informed to make wise purchase decisions, in that (a) they are not aware of all the types of insurance and other products available in the market; (b) they cannot judge the appropriateness or inappropriateness of certain products, and (c) they do not know the true cost of such products.

Id.

A NAIC Suitability Working Group was created in 1998 to produce a white paper as to the advisability of drafting a model law or regulation giving insurers responsibility to determine suitability of sales of life insurance and annuities as a result of a charge assigned to the Life Insurance and Annuities (A) Committee. NAT'L ASS'N OF INS. COMM'RS, SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES 1 (2000), available at <http://www.naic.org> [hereinafter NAIC WHITE PAPER]. The charge was precipitated, in large part, by concerns expressed by the members of two working groups, the Replacement Issues Working Group and the Annuities Working Group. *Id.* See <http://www.naic.org/1committee/suitability/suitwg.htm> (overviewing various comments to these drafts). On March 18, 2002, the Suitability Working Group of the A Committee released a new model regulation addressing the suitability of sales of fixed life insurance and annuities. At the NAIC Summer National Meeting held on June 11, 2002, the A Committee considered but did not adopt the model. See <http://www.naic.org/1papers/models/models.html>.

41. See Letter from Benjamin Y. Brewster, Jr., Director, Government Affairs, New York State Association of Life Underwriters, Inc., to Neil D. Levin, Superintendent State of New York Insurance Department (Nov. 24, 1998) (on file with author); Letter from Donald J. Walters, Senior Counsel, American Council of Life Insurance, to Carolyn J. Johnson, National Association of Insurance Commissioners 8 (Sept. 22, 1999) (on file with author) (concluding that subjectivity of a suitability standard applied to traditional product sales would likely exacerbate existing class action litigation).

42. See N.Y. INS. DEP'T, *supra* note 40, at 10 ("The determination as to suitability for life insurance and annuity products is more subjective than in the securities industry because competent professionals may legitimately disagree as to which products best suit the consumer's needs."); Letter from Life Insurance Council of New York Inc., to N.Y. Insurance Department (Sept. 28, 1998) affixed to N.Y. INS. DEP'T, *supra* note 40, at attachment 3.

Even when the inquiry is expressed as "not unsuitable", a double negative that roughly equates to "not bad for you," the life insurance industry has misgivings about any standard suggesting mandatory suitability, because even within the industry there is a great variety of viewpoint about what products or selling methods are best for the consumer. The industry is concerned that every sale could be subject to an infinity of second guessing and litigation, not because of obvious movements of the market as in securities, but due to shifting sentiment or the conflicting views that could be expressed about a given insurer or agent or given insurance product. In the securities field, nobody ever

outright rejected applying the suitability paradigm employed by the securities industry to the sale of any traditional products.⁴³ As a result, approaches to suitability continue to vary greatly between the securities and life insurance industries.

Nonetheless, many producers of traditional products have utilized certain aspects of variable product suitability standards, such as the benefits of completing a fact finder⁴⁴ and conducting an insurance inventory (life, health, disability, property, and other insurance policies, etc.) in order to compare products.⁴⁵

One apparent difference between variable and traditional product suitability standards is the focus on a customer's "needs." This difference could be attributed to the common belief that a traditional product may be recommended only if it satisfied some

complains about the suitability of a recommendation to buy low and sell high. In life insurance and annuity sales, suitability will be ever more difficult to measure because of the subjective and changing circumstances of a buyer, insured, or beneficiary.

Id. See generally VARIABLE LIFE INS. MODEL REG., II NAIC Model Reg. Serv. 270-32 to -33 (Nat'l Ass'n Ins. Comm'rs) (Jan. 1996).

43. N.Y. INS. DEP'T, *supra* note 40, at 10; see also Letter from Donald J. Walters, Senior Counsel, American Council of Life Insurance, to Carolyn Johnson, National Association of Insurance Commissioners, *supra* note 41 (stating that suitability standards are inapplicable to traditional (non-variable) life insurance and annuity products based on the absence of principal fluctuations and the presumed absence of inherent investment objectives); NAIC WHITE PAPER, *supra* note 40. The proposition that existing laws adequately address market conduct relative to suitability disregards the reality that producers may contemporaneously solicit variable and/or traditional products. Hence, it is ludicrous to assume that the producer would be in a position to realistically safeguard customer best interests by going through somersaults to meet NASD suitability demands for variable sales and then, on the other hand, stand mute as the customer potentially catapults from a cliff of poor decision-making in connection with a fixed-dollar purchase. This hyper-reaction to universal regulation has also led many producers to either ignore, or to take less seriously, the traditional insurance suitability requirements, especially as their insurance licenses are not necessarily jeopardized by such blissful ignorance.

44. See VARIABLE LIFE INS. MODEL REG. § 3(C) cmts. at 270-32. This section was derived, in part, from the NAIC Model Regulation on Deceptive Practices Section 5(g). *Id.* § 3(C) cmts. at 270-31; see also *id.* § 8(C), at 270-18; Michael W. Kessler, *The Suitability Provision of the NAIC Model Variable Life Insurance Regulation*, II NAT'L ASS'N INS. COMM'RS 544 (1974); INS. MARKETPLACE STANDARDS ASS'N ASSESSMENT HANDBOOK 42 (David A. Vaprin ed. 1997) (implementing a principle of ethical conduct) [hereinafter IMSA ASSESSMENT HANDBOOK]; IOWA. ADMIN. CODE § 191-15.8(4) (1999) (stating that suitability analysis for group life insurance or annuities must consider the interests of the intended group policy owner).

45. See MINN. STAT. ANN. § 60K.14 subd. 4 (West Supp. 2002) (requiring producers to compare the values, benefits, and costs of the customer's existing insurance program with the values, benefits, and costs of the recommended policy or policies); N.D. ADMIN. CODE § 45-02-02-14(2)(c) (1999).

articulated customer "need."⁴⁶ A manufacturer's underwriting process also depends on the expression of a definitive purpose for a product purchase in order to avoid anti-selection or speculation.⁴⁷

A needs analysis can be a linear analysis of a customer's financial situation and aspirations.⁴⁸ The "needs" being addressed in life insurance solicitations are usually those of the proposed beneficiaries as viewed through the eyes of the applicant-customer. This type of subjectivity, however, leaves great room for miscalculations and exposure flowing from misjudgments based on second-hand assessments. For instance, a spouse may disagree strongly with the spouse purchasing the product about how much money is needed

46. For instance, Principle 1 of the Insurance Marketplace Standards Association (IMSA) Principles of Ethical Market Conduct, adopted by many life insurance companies, requires that insurers and their producers render services to customers that, in the same circumstances, they would apply to or demand for themselves. IMSA ASSESSMENT HANDBOOK, *supra* note 44, at 42. Code A of this Principle demands that producers "make reasonable efforts to determine the insurable needs or financial objectives of . . . customers based upon relevant information obtained from the customer and enter into transactions which assist the customer in meeting his or her insurable needs or financial objectives." *Id.*; *see also* VARIABLE LIFE INS. MODEL REG. § 3(C), at 270-74; Robert M. Crowe, *Meeting Client Needs Through Financial Planning*, in FUNDAMENTALS OF FINANCIAL PLANNING 1-28 (2d ed. 1993) (discussing financial planning considerations involving all aspects of a customer's financial position); Robbin Derry, *The Ethical Environment of Financial Planning*, in FUNDAMENTALS OF FINANCIAL PLANNING 399, 406-08 (citing The American College's Professional Pledge which supports "customer focused" planning or selling); CODE OF ETHICS OF THE AM. SOC'Y OF CLU & ChFC, Guide 1.1, cmts. A & C, Guide 1.4, *reprinted in* FUNDAMENTALS OF FINANCIAL PLANNING 408-09 (supporting initial and ongoing needs analysis) (the organization is now the Society of Financial Services Professionals); Thomas J. Wolff, *How Much Life Insurance Is Enough?*, in MCGILL'S LIFE INSURANCE 873-84 (1994).

47. JANE L. BROWN, INSURANCE ADMINISTRATION 128, 131-32 (1997); *see also* Letter from Life Insurance Council of New York, to N.Y. Insurance Department (Sept. 28, 1998) affixed to N.Y. INS. DEP'T, *supra* note 40, at attachment 3 (explaining that needs analysis in life insurance uniquely involves insurable interest considerations); Kessler, *supra* note 44, at 543.

48. *See* KENNETH HUGGINS, ET AL., INFORMATION MANAGEMENT IN INSURANCE COMPANIES 320-21 (1995); *see also* Kessler, *supra* note 44, at 542.

In order to be "suitable," any product must reasonably purport to meet the need for which it is purchased as perceived by the purchaser. However, as a product or service becomes more complex, and the purchaser is encouraged and/or compelled as a result of such complexity to rely on the representations of a professional and experienced vendor as to how well the product meets the purchaser's needs, it becomes clear that the seller's conception of these needs and the ability of his product to meet them becomes an equally significant factor in ascertaining "suitability."

Id. A registered representative's perception of a customer's financial objectives is a poor defense to claims of unsuitability where churning is alleged or when unqualified customers trade speculative securities. *See, e.g., In re Keel*, 51 S.E.C. 282, 287 (1993) (finding that representative bears a fiduciary duty to customers about the risks of options trading); *In re Lewis*, 50 S.E.C. 747, 748-49 (1991).

for his or her future sustenance. The highly personal nature of the decisions that a customer must make in deciding among various types and amounts of life insurance has led to speculation that the producer alone bears the ultimate responsibility for inquiring whether the customer "loves their mother or spouse more."⁴⁹

2. Needs Hierarchy

Financial needs could be viewed in terms of a Maslow⁵⁰ type hierarchy of needs. Under this conceptual approach, the most important and largest life needs such as food and shelter, medical, property and casualty insurance, and emergency funds would constitute primary needs that must be secured before resources could begin to be allocated to life and disability insurance or perhaps education, retirement and estate planning. The last "needs" to be satisfied from remaining disposable resources could then be devoted to speculative investments.

Under a needs-hierarchy approach, customers must identify the relative level of resources that they are willing to commit to each tier of "needs." Producers using this conceptual approach might ask their customers to allocate greater resources to primary tiers or, perhaps, to skew resources to a higher tier even though a lower tier may be insufficiently funded. For instance, a customer could buy a life insurance policy even though he or she has little or no emergency funds.

49. Facsimile from Susan N. Skaling, Associate General Counsel, Life Insurance Council of New York, to Section 4228 Coordinating Committee (Aug. 25, 1998) (on file with author).

50. The behaviorist Abraham Maslow developed a theory of human motivation that used a pyramid to designate the hierarchy between physiological needs, safety, love and acceptance, esteem and self-fulfillment. A. H. Maslow, *A Theory of Human Motivation*, 50 *PSYCHOL. REV.* 370-96 (July 1943), cited in ROBERT KREITNER, *MANAGEMENT PRINCIPLES AND PRACTICES* 399-402 (1995); see also DEARBORN FIN. INST., INC., *SERIES 7, GENERAL SECURITIES REPRESENTATIVE LICENSE EXAM MANUAL* 469 fig. 15.1 (10th ed. 1998). The investment pyramid is based on safety oriented instruments such as cash, money-market funds, certificates of deposit, U.S. Treasury securities, bank-grade corporate and municipal bonds, some real estate blue chip stocks, blue chip stock, and bond mutual funds. The next, smaller tier is dedicated to growth instruments such as growth and small-capitalization stocks, stock options, non-bank-grade bonds, growth-oriented limited partnerships, growth stock mutual funds, commodities funds and variable annuities. The top tier of investments is speculative in nature and includes speculative stocks and stock options, low-rated debt securities, precious metals, commodities and futures, speculative limited partnerships, and speculative mutual funds. *Id.*

3. Expense Analysis

A person's need for insurance could also be broadly conceptualized in terms of the following formula:

$$I = (F + E + A + R) - I_1$$

where, I = insurance needed

F = funds to be established, such as education and emergency funds

E = expenses payable, such as estate settlement, mortgage redemption, estate taxes, medical bills and funeral costs

A = ancillary expenses, such as charitable contributions

R = family revenue needed to replace the ordinary and anticipated living expenses formerly paid by the deceased person

I_1 = face amount of in-force insurance

As with any linear model, this analysis may be criticized as being very static and unrealistic if any assumption conflicts with actual results. In other words, the computation does not consider inflation, technological advances, or lifestyle adjustments, among other unforeseeable circumstances.

4. Capital Needs Analysis

Capital needs analysis is another variation of expense analysis. Simply stated, this process may be conceptually described by the following formula:

$$I = (N + PV_{FFO}) - (A + M)$$

where, I = insurance needed

N = all identified capital needs (e.g., debt elimination, education and/or retirement funding, income sources, etc.)

PV_{FFO} = present value of future financial obligations based on presumed interest, inflation, and tax factors

A = available assets

M = available income

In addition to being considered static, this method assumes that all available assets and income will be depleted to satisfy identified needs. Assumptions regarding inflation and future tax structures create the potential for gross deviations from actual future needs. The downward spiral of depleting resources also affects possible assumptions regarding future investment income as well as resulting in a possibly barren estate for contingent beneficiaries.

5. Human Life Value Method

One academic expression of the need for life insurance is to

replace the "human life value" of the insured.⁵¹ This method is typically used in wrongful death litigation and seeks to measure a family's potential loss based on factors such as the income earning potential of the insured over the insured's remaining employable years. This method includes consideration of factors frequently associated with disability insurance, such as the insured's age, occupation, and potential for increased or sustained earned income.⁵²

6. Financial Factors Methods

Life insurance underwriters may consider economic life value, affordability, and existing insurance when determining the maximum insurance available.⁵³ The economic life value factors considered include the apparent relationship of the insured's current income to the projected needs of the beneficiaries.⁵⁴ For example, a 36-year-old insured making \$45,000 per year and providing the sole financial support to three young children could support insurance coverage of \$500,000 to \$750,000 but not \$10 million.⁵⁵

Life insurance underwriters may also judge the affordability of coverage based on either the percentage of income rule (i.e., the 20% rule) or factor tables.⁵⁶ Insurers may use subjective percentage(s) of income as the basis to set the maximum amount that an applicant can afford to pay for coverage. Under the 20% rule, a maximum of 20% of the applicant's gross earned income can be used to pay modal life insurance premiums. Insurers may also use a periodically updated factor table showing the maximum amount of insurance available based on multiples of the applicant's salary or total income and categorized by age.⁵⁷ For instance, an insurer could use a factor table to conclude that a 25-year-old with a current annual income of \$30,000 should not obtain more than \$480,000 (eighteen times average income) in life insurance (absent other factors indicating that the applicant's expected future income potential would support a higher amount of insurance).⁵⁸ A proposed insured may have currently in force an excessive amount of

51. See John E. Scarborough, *The Balance of Life*, 94 LIFE ASS'N NEWS 68 (Jan. 1999) (discussing difference between methods); see also Virginia Simon, *Human Life Value vs. Needs Based Selling*, LIFE & HEALTH ADVISOR (N. Eng.), May 1999, at 4.

52. See Scarborough, *supra* note 51.

53. BROWN, *supra* note 47, at 132-34; see also Kessler, *supra* note 44, at 544-45.

54. BROWN, *supra* note 47, at 132-34.

55. *Id.*

56. *Id.* at 134-36.

57. *Id.*

58. *Id.*

insurance relative to his or her economic value.⁵⁹ Insurers may include accidental death benefit coverage, personal insurance, and business insurance into these considerations.⁶⁰

7. Business Financial Factors Methods

Business insurance needs feature many of the same factors considered for personal insurance. Financial assessment for business insurance focuses on the financial condition of the business, its capacity to pay premiums, and the anticipated loss suffered by the death of the proposed insured.⁶¹

C. Variable Products

In addition to the general fairness standards,⁶² the NASD Conduct Rules and interpretations thereof establish the following extensive requirements for variable product suitability.⁶³

1. Variable Annuities

The suitability analysis associated with the sale of variable annuities has captured the attention of commentators,⁶⁴ regulators, and the plaintiffs' bar.⁶⁵ The NASD approach to variable annuity suitability expands otherwise applicable suitability analyses by "suggesting" that registered representatives consider the following best practices:

- Make reasonable efforts to obtain comprehensive, complete, and accurate customer information, "including the customer's occupation, marital status, age, number of dependents, investment objectives, risk tolerance, tax status, previous investment experi-

59. *Id.*

60. *Id.* at 136.

61. *See id.* at ch. 7.

62. Fair Dealing with Customers, NASD Conduct Rule IM-2310-2, NASD Manual & Notices to Members (1998), available at <http://secure.nasdr.com/wbs/NETbos.d11?Refshow?net=NASD4;&info=/goodbye.htm>.

63. *See supra* Part I.A for a discussion of the NASD non-"sophisticated" securities investor suitability rule. *See generally* Suitability, NASD Conduct Rule 2860(b)(19), NASD Manual & Notices to Members (1998), available at <http://secure.nasdr.com/wbs/NETbos.d11?Refshow?net=NASD4;&info=/goodbye.htm> (defining suitability standards for option contracts); 17 C.F.R. § 240.15g-9(b) (2001) (establishing requirements for low-priced securities).

64. *See, e.g.,* David Snyder, *Enforcement Spotlight: Variable Products*, LIMRA's MARKETFACTS, Sept.-Oct. 1998, at 10.

65. *See, e.g.,* Soranno v. N. Y. Life Ins. Co., No. 96 C 7882, 2000 U.S. Dist. Lexis 14073, at *11 (N.D. Ill. Sept. 20, 2000) (discussing misrepresentations/omissions regarding interest rates).

ence, liquid net worth, other investments and savings, and annual income.”⁶⁶

- “[R]eview the customer’s investment objectives, risk tolerance, and other information to determine that the variable annuity contract as a whole and the underlying subaccounts recommended to the customer are suitable.”⁶⁷
- “[C]ompare the information in the account application with other relevant information sources, e.g., an account information form, to check for apparent accuracy and consistency.”⁶⁸
- Determine the duration of the customer’s objectives inasmuch as short-term objectives may lead to surrender charges or penalties for early withdrawal under the Internal Revenue Code.⁶⁹
- “[C]onduct an especially comprehensive suitability analysis prior to approving the sale of a variable annuity with surrender charges to a customer in a tax-qualified account subject to plan minimum distribution requirements.”⁷⁰

2. Variable Life Insurance

In addition to the general securities suitability standards mentioned above, the NASD has provided the following non-exclusive factors that could be considered by producers in assessing suitability requirements pertaining to variable life products:

- A representation by the customer as to whether his or her life insurance needs have been met through existing life insurance;⁷¹
- An express desire to buy an investment as compared to an insurance product;⁷²
- A customer’s understanding about how the premiums are allocated among product costs and expenses and the complexity of variable insurance products generally;⁷³
- Affordability of premiums and the source of premium funding (i.e., policy financing);⁷⁴

66. NTM 99-35, *supra* note 11, ¶ 1.

67. *Id.* ¶ 4. See generally Booth, *supra* note 9, at 1605-09 (diversification).

68. See NTM 99-35, *supra* note 11, ¶ 4.

69. See *id.* ¶ 8.

70. See *id.* ¶ 12; see also United States Securities and Exchange Commission, Variable Annuities: What You Should Know, at <http://www.sec.gov/investor/pubs/varannty.htm> (last modified Apr. 5, 2001).

71. NTM 96-86, *supra* note 36.

72. *Id.*

73. *Id.*

74. NTM 00-44, *supra* note 10. Policy financing involves the payment of premiums through the use of loans of cash values from an existing policy for so long as the original policy can sustain such withdrawals.

- When the proceeds will be needed;⁷⁵
- Whether the product was sold for retirement needs;⁷⁶
- Customer investment sophistication and capability to monitor performance.⁷⁷

In contrast to the apparent reluctance to embrace a universal standard applicable to traditional products, state insurance laws do affirm the benefits of a clear suitability standard applicable to variable life products.⁷⁸ In June 1974, the National Association of Insurance Commissioners ("NAIC") adopted a definition of "suitability" in the context of model variable life insurance regulation.⁷⁹ This definition was based on securities laws and a need to harmonize such laws with insurance regulations.⁸⁰ The following priorities were suggested for conducting this analysis:

"Suitability" means the likelihood that the purchase of variable life insurance is reasonably consistent with: (1) the expressed insurance objectives and needs as perceived by the prospective insured; (2) the reasonable objectives and needs of the prospective insured as determined objectively by a professional agent after a diligent reasonable inquiry into relevant financial, family and other background information concerning the prospective insured; and (3) the potential that the prospective insured will persist with the policy for such a period of time that the insurer's

75. NTM 96-86, *supra* note 36.

76. *Id.*

77. *See id.*

78. All insurers seeking to sell variable life insurance policies in a state that has adopted the NAIC Variable Life Insurance Model Regulation must also establish and maintain a written statement specifying its suitability standards. VARIABLE LIFE INS. MODEL REG. § 3(C), II NAIC Model Reg. Serv., 270-74 (Nat'l Ass'n Ins. Comm'rs, Inc.) (Jan. 1996). As of October, 1999, thirty-eight states have adopted either the model act or a related version of the same. *Id.* at 270-69 to -72. *See generally* Dist. Bus. Conduct Comm. for Dist. No. 8 v. Cruz, No. C8A930048, 1997 WL 33101218 (Nat'l Bus. Conduct Comm. Oct. 31, 1997) (finding that suitability analysis must be performed to the product as a whole, not just the securities aspects of the product, and a registered representative has a responsibility to perform an independent suitability assessment).

79. VARIABLE LIFE INS. MODEL REG., at 270-32 to -33. Standards of Suitability adopted by the Board of Directors and filed with the Commissioner had to include a suitability requirement. Kessler, *supra* note 44, at 541.

80. NAIC counsel summarized this initiative as follows:

While the actual language . . . is based on SEC Rule 15b 10-3, the concept of suitability is not foreign to insurance. In fact, those who saw the earlier drafts of the model regulation will recall that the suitability provisions were more extensive than at present. They were modified at the suggestion of several SEC staff members and insurance industry representatives who expressed concern ensuing from a potential conflict between the NAIC and SEC requirements.

Kessler, *supra* note 44, at 542 (footnote omitted).

acquisition costs are amortized over a reasonable period of time When variable life insurance meets characteristics (1) and (3) or (2) and (3), it is probably still "suitable" in most instances Variable life insurance is clearly "unsuitable" when it meets none of the three characteristics for a given prospect Variable life insurance is probably "unsuitable" in the absence of extraordinary factors when it does not meet characteristic (3) Other situations must be judged on their individual facts.⁸¹

In adopting the 1983 amendments to the Variable Life Insurance Model Regulation, the NAIC recognized that the resulting proliferation of variable life insurance product designs might make suitability, and particularly factors (1) and (2), even more important.⁸² On the other hand, the NAIC understood that the possibility of more variable life insurance products designed to compete with investment-oriented products of other financial institutions would make persistency, as articulated in factor (3), less significant because policyholders would be more likely to move among competing financial institution products for reasons such as rate of return, tax considerations, and economic conditions.⁸³ As a result, the NAIC made persistency less relevant as a measure of suitability.⁸⁴

The decision to recoil from persistency⁸⁵ is a noteworthy retreat from very strong sentiments about its overall relevance to suitability analysis and the public image of the industry.⁸⁶ The pre-1983 version of the Model Act acknowledged that suitability was a difficult area to police and that an objective criterion, such as lapse rates, would be an accurate yardstick.⁸⁷ Nine years later, however, these factors were considered to be irrelevant in traditional products⁸⁸ and to suitability.⁸⁹ A newer view blamed lapse rates on policyholders and non-producer related circumstances.⁹⁰ In doing so,

81. VARIABLE LIFE INS. MODEL REG., at 270-32 to -33.

82. *Id.*

83. *See id.* at cmt.

84. *See* Kessler, *supra* note 44, at 542.

85. *See id.* at 543.

86. *Id.*

87. VARIABLE LIFE INS. MODEL REG., at 270-32 to -33; *see also* Kessler, *supra* note 44, at 541 ("The inclusion of a suitability provision was in partial response to a concern of the NAIC that variable life insurance might be missold and/or oversold, with the resultant possibility that early lapses might be numerous.").

88. VARIABLE LIFE INS. MODEL REG., at 270-32 to -33.

89. *Id.* at 270-34.

90. *See id.*

this view disregarded the previous subcommittee's call "for insurance regulators to require and instill in insurers the commitment to underwrite for suitability (including persistency) . . . for the benefit of themselves, their agents, the policyholders, and the public."⁹¹

D. *Transaction Specific Suitability Standards*

Various regulatory bodies have adopted regulations and issued warnings⁹² to deter twisting and indiscriminate replacements⁹³ of one insurance product for another. These admonitions have also been applied to replacing bonus annuities on the presence of a "bonus credit" (i.e., features that offer the investor an immediate credit equal to a percentage of purchase payments that may otherwise offset applicable contingent deferred sales charges pertaining to the early surrender of an existing annuity).⁹⁴

According to the New York legislature, replacements are a "special circumstance in which insurance consumers need additional protections to avoid adverse consequences."⁹⁵ New York's "minimum standards of conduct" for transactions considered "replacements" require producers to make available "full and clear information in which an applicant can make an informed decision in his or her own best interest."⁹⁶ The "full and clear information" needed for the customer to make an "informed decision" represents a disclosure-oriented approach that shifts responsibility to the customer through the provision of prescribed disclosures, provided that the producer and manufacturer can demonstrate that a needs

91. Kessler, *supra* note 44, at 546.

92. See, e.g., Paul Roye, Director, Division of Investment of Management, U.S. Securities & Exchange Commission, Understanding the Securities Products of Insurance Companies, Keynote address before the Practising Law Institute (Jan. 9, 2001) available at <http://www.sec.gov/news/speech/spch455.htm>; State of N.Y., Insurance Department, Circular Letter No. 21 (June 21, 2000), available at http://www.ins.state.ny.us/c100_21.htm.

93. For a generally accepted definition of the term "replacements," see N.Y. COMP. CODES R. & REGS., tit. 11, § 51.2(a) (1998).

94. See Recommendations to Customers (Suitability), *supra* note 7.

95. N.Y. INS. DEP'T, *supra* note 40, at 9.

96. N.Y. COMP. CODES R. & REGS., tit. 11, § 51.1(b) (1998); see also LIFE INS. & ANNUITIES REPLACEMENT MODEL REG. § 1(A)(2)(a), III NAIC Model Reg. Serv. 613-1 (July 2000); NTM 00-44, *supra* note 10, at 302 (detailing best interest test applied to replacement of variable life products). See generally IMSA ASSESSMENT HANDBOOK, *supra* note 44, at 62, 67; James M. Carson & Mark D. Forster, *Suitability and Life Insurance Policy Replacement: An Analytical Tool*, 18 J. INS. REG. 427447, July 1, 2000, 2000 WL 21046589 (providing critical analysis of Life Insurance and Annuities Replacement Model Regulation).

analysis occurred.⁹⁷ Worksheets⁹⁸ and other materials have therefore been developed to better document the basis for recommendations described in such state mandated disclosure forms.⁹⁹

The NASD's approach to variable product replacements also generally follows this quasi-disclosure approach. NASD Notice to Members 99-35 expands disclosure duties by obligating registered representatives, broker-dealers¹⁰⁰ and wholesalers¹⁰¹ to ensure the suitability of a variable annuity replacement¹⁰² by considering whether such matters as product enhancements and improvements, lower cost structures, and surrender charges justify a replacement of an existing annuity.¹⁰³ For instance, a producer replacing one annuity with another based on the performance of the former must

97. See LIFE INS. & ANNUITIES REPLACEMENT MODEL REG., § 1(A)(2)(b) & app. A, at 613-11; NTM 00-44, *supra* note 10, at 302 (describing replacement forms).

98. See generally NTM 00-44, *supra* note 10, at 302; Books and Records, NASD Conduct Rule 3110, NASD Manual & Notices to Members (1998) available at <http://secure.nasdr.com/wbs/NETbos.d11?Refshow?ref=NASD4;&info=/goodbye.htm> (requiring brokers to maintain customer account information regarding the nature of the customer and their authority); Diligence as to Accounts, N.Y.S.E. Rule 405(1), 2 N.Y.S.E. Guide (CCH) ¶ 2405, at 3696 (Aug. 1994); 17 C.F.R. § 240.15c2-5(a)(2)(1999)(equity funding programs); 17 C.F.R. § 240.15g-9(b)(3) (penny stocks); Anderson & Winslow, *supra* note 9, at 120 (stating that customers should receive written confirmation of their expressed investment objectives).

99. See, e.g., N.Y. Regulation 60, 11 N.Y.C.R.R. App. 10A & 10B (1998) (containing in its disclosure forms questions that must be completed by all producers effecting a "replacement": (1) What are the primary reason(s) for this recommendation; (2) Why can't the existing product meet the customer's objective; (3) What are the advantages of continuing the existing products without changes); see also LIFE INS. & ANNUITIES REPLACEMENT MODEL REG., apps. A-C, at 613-12 to -15.

100. See NTM 99-35, *supra* note 11, at subdiv. 16 (stating that a retail member should adopt other measures reasonably designed to ensure that replacement sales activity by its registered representatives complies with NASD rules).

101. See *id.*

Members that "wholesale" variable annuities are reminded that they are also subject to NASD rules, and that they should avoid marketing strategies that are designed primarily to encourage inappropriate replacement sales. Upon reasonable request and to the extent practical, wholesale members should assist retail broker/dealers in monitoring the replacement activity of their customers.

Id. The foregoing leaves open the question of whether the wholesaler must refuse to cooperate with a manufacturer who developed a marketing strategy that could run afoul of this prohibition.

102. Exchange Act Rule 15g-9, 17 C.F.R. § 240.15g-9(b) (1999); Investor Tips, Variable Annuities: What You Should Know, at <http://www.sec.gov/investor/pubs/varanntty.htm>; NTM 99-35, *supra* note 11, at subdiv. 14; see also NASD Regulation Investor Alert, Should You Exchange Your Variable Annuity?, at http://www.nasdr.com:80/alert_02-01.htm.

103. NTM 99-35, *supra* note 11, at subdiv. 14.

be prepared to defend his or her sale¹⁰⁴ on the basis that, among other things, the former annuity had been substantially under-performing relative to its peers for a substantial time period.

II. SUITABILITY BASED LIABILITY

Suitability claims account for the vast majority of the filings under NASD members' errors and omissions policies.¹⁰⁵ One commentator noted that suitability has evolved into a duty without a standard.¹⁰⁶ This duty has been described as one of care,¹⁰⁷ to warn,¹⁰⁸ monitor,¹⁰⁹ protect,¹¹⁰ improve,¹¹¹ and even prevent "economic suicide."¹¹² Recommendations carry an "implicit warranty of soundness"¹¹³ or something in the nature of a "warranty of fitness for a particular purpose."¹¹⁴ Proof of meeting the quest for equifinite results satisfying this ethical mandate¹¹⁵ is measured ex post facto, at the urging of a hapless customer¹¹⁶ by arbitrators.¹¹⁷ Moreover, these arbitrators consider the ex ante expectations of the

104. See NTM 01-23, *supra* note 11, at n.4.

105. Zarb Urges Broker-Dealers to 'Be on Guard' About Suitability, 30 Sec. Reg. & L. Rep. (BNA) No. 22, at 810 (May 29, 1998); see also Press Release, NASD Regulation, Inc., NASD Regulation Files Six Enforcement Actions Involving Marketing and Sales of Variable Annuities (Feb. 15, 2001) (on file with author).

106. See Rapp, *supra* note 9, at 191-92.

107. *Id.* at 190-91.

108. *Id.* at 212-27.

109. *Id.*

110. See Kerr, *supra* note 9, at 806-07 (discussing the duty to invest prudently, not speculate, diversify, and seek productive portfolios in guidelines).

111. See *id.* at 806 (asserting increased productivity as one of many vague guidelines).

112. Rapp, *supra* note 9, at 212-27 (stating that economic suicide could be described as making fool-hearty investments leading to financial ruin).

113. Kahn v. SEC, 297 F.2d 112, 115 (2d Cir. 1961) (Clark, J., concurring).

114. Mundheim, *supra* note 9, at 452.

115. The Securities and Exchange Commission has interpreted NASD suitability standards as being an ethical yardstick for measuring producer conduct. See *In re Burkes*, 51 S.E.C. 356, 360 (1993); Mundheim, *supra* note 9, at 464-67 (noting that the concept of suitability originated, and was intended to remain, as an ethical principle).

116. See Rapp, *supra* note 9, at 191-92, 212 n.94.

117. Suitability claims are more likely to be addressed through arbitration following the U.S. Supreme Court decisions. See *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987); *Rodriquez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477 (1989). See generally Rapp, *supra* note 9, at 192 n.9 (stating that arbitration panels now decide most suitability claims). Courts and juries have been criticized as being poor arbiters of suitability based on their proclivity to craft unintended remedies through the application of equitable principles such as the rule of contra profentum, the implied covenant of good faith and fair dealing, and common law detrimental reliance. This is an unfortunate result as "[c]ourts are institutionally ill-suited" to make these types of decisions based on their ex post litigation perspective. Mark A. Hall & Gerard F. An-

producer, and not the customer,¹¹⁸ on a case-by-case, investment-by-investment basis,¹¹⁹ unrestrained by precedent or consistency.¹²⁰

A variety of theories or initiatives have been proffered in support of holding producers liable for the outcomes of their recommendations. It is too early to tell how functional regulatory powers vested under the Gramm-Leach-Bliley Act,¹²¹ and the overall constraints now placed on state legislatures in adopting or amending suitability guidelines,¹²² will expand or curtail these bases for exposure.

A. *The Shingle Theory*

But what about this man who sells insurance? Surely his persistency is part of American Folklore, whether it is his foot, which is in the door, his calendar in the mail, or his voice in the telephone receiver. Professional man or salesman? Which is he? A man on his own or someone else's man? A huckster in the marketplace or an expert on whom you can rely?¹²³

Producers have been held accountable for unsuitable sales and overall breach of fairness standards under a so-called "shingle theory."¹²⁴ By "hanging out" his or her shingle, and holding himself or

derson, *Health Insurers' Assessment of Medical Necessity*, 140 U. PA. L. REV. 1637, 1679 (1992).

118. See Rapp, *supra* note 9, at 213.

119. See *id.* at 191 n.5, 241 (considering suitability based on overall portfolio).

120. See *id.* at 216-17, 263 n.315, 264-78 (discussing the shortcomings of the existing regulations and proposed remedies).

121. Gramm-Leach-Bliley Act, Pub. L. 106-102, § 301, 113 Stat. 1338 (1999) (providing that insurance activities of any persons shall be "functionally" regulated by the States subject to section 104 of the Act); *id.* tit. III, subtitle A (permitting national banks to engage in certain additional insurance activities); *id.* § 305 (amending the Federal Deposit Insurance Act by requiring that Federal banking agencies publish customer protection regulations applicable to retail sales practices and solicitations by November 12, 2000, including "Customer Protection Disclosures" that will alert consumers to investment risks associated with variable products).

122. Suitability is not among the thirteen general safe harbors with respect to state laws that may not be pre-empted. See *id.* § 104(d)(2)(B). Those statutes existing prior to September 3, 1998, will continue to benefit from the reverse preemption application of the McCarran-Ferguson Act. See *id.* § 104(d)(2)(C)(i). All other attempts to enact state laws in regard to bank sold insurance products will be affected by the legal standards for preemption set forth in *Barnett Bank of Marion County v. Nelson*, 517 U.S. 25, 28-37 (1996).

123. Thomas J. Ziomek & Jane O. McCahill, *Legal Liability of Agents and Brokers*, J. FIN. SERV. PROFS. 64, 66 (Jan. 1999) (quoting Bartram Hartnett, RESPONSIBILITIES OF INSURANCE AGENTS AND BROKERS § 1.01 (1997)).

124. Phillip E. Stano & Carl B. Wilkerson, *A Discussion of Insurers' Vicarious Liability for Agents' Wrongdoing*, 6 NAT'L. INS. L. REV. 809, 845-47 (1993). See gener-

herself out as someone who is knowledgeable about financial products, the producer implies that he or she will deal fairly with customers according to the standards and practices of the profession.¹²⁵ Accordingly, a producer's business card and directory listing can be a basis for customers to expect that the producer would not recommend products with no reasonable basis to support such a recommendation.¹²⁶

In addition to producer exposure under this theory, one can argue that in certain instances, manufacturers could be held responsible for their producers. For example, an advertisement used to promote producers as "financial advisers" could support a claim against the manufacturer when the producers do not have the requisite credentials supporting this designation.¹²⁷ General agency law,¹²⁸ concepts of respondeat superior,¹²⁹ and the implied cove-

ally Berko v. SEC, 316 F.2d 137, 143 (2d Cir. 1963); *Anderson v. Knox*, 297 F.2d 702 (9th Cir. 1961); *In re Tallman*, Exchange Act Release No. 8830, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,800, at 83,848 (Mar. 2, 1970); *In re Whitman & Stirling Co.*, 43 S.E.C. 181, 182-83 (1966); Investment Advisers Act Release No. 1A-1406, 56 S.E.C. Docket (CCH) 724, 725 n.6 (Mar. 16, 1994) (applying shingle theory to investment advisers); REPORT OF COMM'R LAURA S. UNGER TO THE U.S. SEC. & EXCH. COMM'N, H.R. DOC. NO. 95, at 238 (1st Sess. 1963) (A 1963 Securities and Exchange Commission Special Study of the Securities Markets specifically identified suitability as a distinct doctrine giving rise to both a legal obligation under antifraud provisions and an ethical duty under SRO rules). One commentator has noted that use of designations such as "financial adviser" or "financial consultant" is tantamount to invitations for suitability claims under the shingle theory. See Rapp, *supra* note 9, at 190 n.3, 196-202, 263. These claims become especially colorable when producers act as "financial interior decorators" by performing simplistic matching of generic client types with generic types of investments. *Id.* at 221-22, 237-38; see also RULES GOVERNING THE ADVERTISING OF LIFE INSURANCE § 5(N), III NAIC Model Reg. Serv. 570-5 (Nat'l Ass'n Ins. Comm'rs) (Apr. 1995). For a discussion of the shingle theory in the context of a negligence and fraud claim, see *Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co.*, 682 P.2d 388, 402-05 (Ariz. 1984).

125. Stano & Wilkerson, *supra* note 124, at 846; see *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 436-37 (2d Cir. 1943); Burke A. Christensen, *Agents and Brokers*, in MCGILL'S LEGAL ASPECTS OF LIFE INSURANCE 246-47 (Edward E. Graves & Burke A. Christensen eds., 1996); Eileen B. Eglin & Richard J. Rogers, *Agents' and Brokers' Liability: Understanding Their Integral Role*, in INSURANCE LAW-WHAT EVERY LAWYER AND BUSINESSPERSON NEEDS TO KNOW 111, 116 (1997); 8 HOLMES' APPLEMAN ON INSURANCE 2D § 52.2(B), at 420-23 (1998).

126. See Stano & Wilkerson, *supra* note 124, at 846.

127. See generally ADVERTISEMENTS OF LIFE INS. & ANNUITIES MODEL REG. § 5(N), III NAIC Model Reg. Serv. 570-5 (Nat'l Ass'n Ins. Comm'rs) (July 2000).

128. See Christensen, *supra* note 125, at 232; Dan M. McGill, *Waiver, Estoppel, and Election by the Insurer*, in MCGILL'S LIFE INSURANCE 803 (Edward E. Graves ed., 1994).

129. See generally *Pac. Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1, 13-15; Christensen, *supra* note 125, at 244-47; Stano & Wilkerson, *supra* note 124 (discussing vicarious liability under respondeat superior doctrine).

nant of good faith and fair dealing¹³⁰ also provide potential bases for claims against manufacturers.¹³¹

B. *Fraud Theories*

The Ninth Circuit, in *Anderson v. Knox*, first endorsed the enforcement of suitability requirements as a fraud concept in the context of an insurance policy.¹³² In that case, a producer who had induced a customer to purchase excessive amounts of bank-financed insurance was liable for damages because the policies were unsuitable to the plaintiff's needs.¹³³ Common law fraud theories, as compared to the anti-fraud provisions of Rule 10b-5 of the Securities Exchange Act,¹³⁴ may also find favor with customers based on their appeal to arbitrators¹³⁵ and the relative ease with which

130. See ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW* § 6.2(a)(2) at 624-26 (Practitioner's ed. 1988); Stano & Wilkerson, *supra* note 124, at 846; see also Securities Exchange Act of 1934 Rule 10b-5, 17 C.F.R. § 240.10b-5, 3 Fed. Sec. L. Rep. (CCH) ¶ 22,725, at 16,610 (Apr. 16, 1997). The covenant of good faith and fair dealing applied to insurance contracts does not merely "connote the absence . . . of positive misconduct of a malicious or immoral nature," it demands that the insurer act reasonably to fulfill the justified expectations of the other party. *Neal v. Farmers Ins. Exch.*, 21 Cal. 3d 910, 922 n.5, 925 (1978). See generally U.C.C. § 1-203 (West Supp. 1999) (requiring good faith performance of all contracts); 14 COUCH ON INSURANCE 3d § 198:14 (Dec. 1999) (comparing good faith and fiduciary duties).

131. See Part II.D.

132. 297 F.2d 702 (9th Cir. 1961). See generally VARIABLE LIFE INS. MODEL REG. § 4(D) cmts., II NAIC Model Reg. Serv., 270-34 (Nat'l Ass'n Ins. Comm'rs) (Jan. 1996) ("[T]he commissioner as a practical matter probably possesses the power to rescind a sale based on a material misrepresentation. Common law fraud causes of action, as well as implied rights of action, also may exist depending on the law of each individual state."). But see *Royal Am. Managers, Inc. v. IRC Holding Corp.*, 885 F.2d 1011, 1016 (2d Cir. 1989) (finding that justifiable reliance was needed to substantiate a common law fraud claim).

133. *Anderson v. Knox*, 297 F.2d 702, 728-29 (9th Cir. 1961).

134. 17 C.F.R. § 240.10b-5 (1998); see also Securities Exchange Act of 1934, §§ 10(b) & 15(c), 15 U.S.C.A. §§ 78j(b) & 78o(c)(1) (West Supp. 1999); Rule 15c1-2, 17 C.F.R. § 240.15c1-2 (1999). The elements of a Rule 10b-5 claim are: "(a) a false representation of (b) a material (c) fact; (d) defendant's knowledge or reckless disregard of its falsity and their intention that plaintiff rely on it; (e) plaintiff's reasonable reliance thereon; and (f) plaintiff's resulting loss." *Lewis v. Chrysler Corp.*, 949 F.2d 644, 649 (3d Cir. 1991); see also *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020 (2d Cir. 1993); *O'Connor v. R.F. Lafferty & Co.*, 965 F.2d 893, 897 (10th Cir. 1992); *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 600-01 (2d Cir. 1978) (stating that a violation of NASD suitability rule may not be a per se violation of Rule 10b-5); Booth, *supra* note 9, at 1602-05; Langevoort, *supra* note 16, at 889-903; Lowenfels & Bromberg, *supra* note 9, at 1585-89.

135. Prior to its rescission in 1983, salespeople who were not members of a self-regulatory authority were bound by the suitability provisions of Rule 15b10-3 of the Securities Exchange Act of 1934. Exchange Act Release No. 20,409 (Nov. 22, 1983), Fed. Sec. L. Rep. [1983-1984 Transfer Binder] (CCH) ¶ 83,457 (Dec. 7, 1983); see 15

they can be pleaded.¹³⁶ Nevertheless, courts borrow heavily from securities laws when analyzing fraud claims.¹³⁷ The factors considered in framing a fraud claim therefore include misrepresentation/omission,¹³⁸ reliance,¹³⁹ and possibly scienter.¹⁴⁰

U.S.C.A. § 78o-3v (West Supp. 1999). Presently, the principal forum for addressing private actions for damages based on suitability has shifted to the arbitration tribunals of the NASD and other self-regulatory organizations and tribunals. See Booth, *supra* note 9, at 1600 n.6, 1604; Lowenfels & Bromberg, *supra* note 9, at 1584, 1593-97; Rapp, *supra* note 9, at 192 n.9.

136. See FED. R. CIV. P. 9(b) (stating that fraud must be stated with particularity whereas intent, knowledge, and other conditions of the mind of a person may be averred generally); see also *In re* The Prudential Ins. Co. of Am. Sales Practices Litig., 975 F. Supp. 584, 596-98, 613-15 (D.N.J. 1996); Berent v. Kemper Corp., 780 F. Supp. 431, 440-41 (E.D. Mich. 1991) *aff'd*, 973 F.2d 1291 (6th Cir. 1992). See generally Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993) ("Analytically, an unsuitability claim is a subset of the ordinary § 10(b) fraud claim in which a plaintiff must allege, *inter alia*, (1) material misstatements or omissions, (2) indicating an intent to deceive or defraud, (3) in connection with the purchase or sale of a security."); Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982, 986-87 (10th Cir. 1992) (quoting Sears v. Likens, 912 F.2d 889 (7th Cir. 1990)) (ruling that pleadings must state "what misrepresentations were made by the defendant, to whom these misrepresentations were made, when these misrepresentations were made, or how these misrepresentations furthered the alleged fraudulent scheme"); Olpin v. Ideal Nat'l Ins. Co., 419 F.2d 1250 (10th Cir. 1969) (finding that life insurance policies are not securities under the Securities Act thereby eliminating a cause of action under the anti-fraud provisions of the Securities Exchange Act); Assocs. in Adolescent Psychiatry, S.C. v. Home Life Ins. Co. of N.Y., 729 F. Supp. 1162 (N.D. Ill. 1989), *aff'd*, 941 F.2d 561 (7th Cir. 1991) (to like effect); Otto v. Variable Annuity Life Ins. Co., 611 F. Supp. 83 (N.D. Ill. 1985), *aff'd in part, rev'd in part*, 814 F.2d 1127 (7th Cir. 1986) (discussing anti-fraud claims dismissed because subject annuities came within Securities Act exemption).

137. See *In re* The Prudential Ins. Co. of Am. Sales Practices Litig., 975 F. Supp. 584, 613 (D.N.J. 1996); see also Booth, *supra* note 9, at 1603 n.20; Lowenfels & Bromberg, *supra* note 9, at 1589-91; Letter from Donald J. Walters, Senior Counsel, American Council of Life Insurance, to Carolyn Johnson, *supra* note 43, at 6 (stating that Rule 10b-5 fraud analysis is inapposite to suitability analysis).

Customers may find that class action suitability claims must be framed in terms of Rule 10b-5 claims in order to avoid federal civil procedure impediments imposed under the Private Securities Litigation Reform Act of 1995, 15 U.S.C.A. §§ 77z-1 to 78u-4 (West 1994 & Supp. 2001). See Lander v. Hartford Life & Annuity Ins. Co., 251 F.3d 101 (2d Cir. 2001) (finding alleged misrepresentation of the tax benefits of variable annuities when purchased through tax-qualified investment plans and failure to disclose fees).

138. See *In re* The Prudential Ins. Co. of Am. Sales Practices Litig., 975 F. Supp. at 613-14.

139. *Id.* at 613-15; see also Brown v. Lockwood, 432 N.Y.S.2d 186, 193-95 (App. Div. 1980).

140. See Clark v. John Lamula Investors, Inc., 583 F.2d 594, 600 (2d Cir. 1978); see also Private Securities Litigation Reform Act, 15 U.S.C.A. § 78j-1 (West Supp. 1999) (requiring that private litigants suing under Rule 10b-5 must plead scienter with particularity and without the benefit of discovery); Lowenfels & Bromberg, *supra* note 9, at 1588-89; *In re* Olde Disc. Corp., Sec. Exchange Act Release No. 40423, 1998

C. *Fiduciary Liability*

In addition to the shingle and fraud theories, producers may be held liable as fiduciaries. Producers have been measured under standards as someone with a higher than ordinary sense of care,¹⁴¹ similar to priests,¹⁴² common law fiduciaries,¹⁴³ professionals,¹⁴⁴ ex-

WL575171, at *21 (1998) (holding that broker's management environment encouraged unsuitable sales).

141. See HOLMES, *supra* note 125, at 420-23. See generally SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) (stating that an investment adviser is a fiduciary and has an affirmative duty of "good faith" and "full and fair disclosure of all material facts" to each client); Kessler, *supra* note 44, at 541.

142. See Myles A. Tracy, *Insurance and Theology*, 33 J. RISK & INS. 85, 91 (1966); Alexander Welsh, *The Agent As Priest*, THE CHRISTIAN CENTURY 1574, 1576 (1963). Associations between insurance solicitation and religious organizations and concepts can be traced back to the formation of the first U.S. life insurance company in 1759 by the Presbyterian Synod of Philadelphia and the use of collective trusts by religious guilds. J. OWEN STALSON, *MARKETING LIFE INSURANCE* 34, 44 (1942). Episcopalians established their own company in 1769. Michael D. White, *True Believers*, NAT'L UNDERWRITER, Sept. 13, 1993, at 19 (Life & Health/Financial Services ed.). In the nineteenth century, American Revivalists objected to the sale of life insurance on "religious" grounds on the basis that, among other things, it tempted divine Providence. See JOHN GUDMUNDSEN, *THE GREAT PROVIDER* 44 (1959); STALSON, *supra* at 67, 150; VIVIANA A. ROTMAN ZELIZER, *MORALS & MARKETS* 73-79 (1983). Several marketing approaches were developed to overcome this obstacle. First, the concept of Providence was reinterpreted as an active responsibility to use human foresight to safeguard the future. See generally SOLOMON S. HEUBNER, *LIFE INSURANCE* 23 (4th ed. 1950). Second, the insurance companies developed marketing terminology that resonated in religious imagery. See Carole King, *Religion of Life Insurance Needs Revival in New Form*, NAT'L UNDERWRITER, Dec. 18, 1995, at 7 (Life & Health/Financial Services ed.), available at 1995 WL 11948458; ZELIZER, *supra* at 122-39.

143. See also HOLMES, *supra* note 125; Booth, *supra* note 9, at 1602-05; Lowenfels & Bromberg, *supra* note 9, at 1591-92. See generally RESTATEMENT (SECOND) OF AGENCY §§ 1, 13, 387, 393-94, 399-401, 407, 425 (1958). For blue sky laws specifically identifying investment advisors as fiduciaries, see IND. ADMIN. CODE tit. 710, r. 1-16-22(a), 2 Blue Sky L. Rep. (CCH) ¶ 24,613M, at 19,475-17 (Jul. 1999); MD. BLUE SKY REG. r. 03(B), 2 Blue Sky L. Rep. (CCH) ¶ 30,453, at 25,4279-80 (Mar. 2002); R.I. GEN. LAWS §§ 18-15-2 to -4,02 (2000) (banks and trustees). See generally Christensen, *supra* note 125, at 244-47. For cases and articles that consider whether a producer is a fiduciary, see *Lieb v. Merrill Lynch, Pierce, Fenner & Smith*, 461 F. Supp. 951, 953 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981) (finding that discretionary account securities brokers become fiduciaries); *In re First Secs. Corp.*, 40 S.E.C. 589, 590 (1961) (finding that excessive trading (churning) is a breach of a registered representative's "position of trust" under a duty to act in the customer's best interests); *Beardmore v. Abbott*, 218 So.2d 807, 809 (Fla. Dist. Ct. App. 1969) (producer fiduciary); *Kanter v. Deitelbaum*, 648 N.E.2d 1137, 1139 (Ill. App. 1995) ("The relationship between an insured and his [health insurance] broker, acting as the insured's agent, is a fiduciary one, despite the fact that the broker may be compensated by a third party."); *Coping with the Crash: A Step-by-Step Guide to Investor Rights*, NASAA Reports (CCH) ¶12,121, at 12,127 (1987) (analogy to trustee); Burke A. Christensen, *Insurance Agent or Broker Liability to the Insured*, 10 J. INS. REG. 313-41 (Spr. 1992); Eileen B. Eglin & Richard J. Rogers, *Agents' and Brokers' Liability: Understanding Their Integral Role*, in *INSUR-*

perts,¹⁴⁵ fiduciaries under the Employee Retirement Income Security Act of 1974 (ERISA),¹⁴⁶ or trustees.¹⁴⁷ The ratcheting fidelity thresholds associated with each of these labels present special con-

ANCE LAW-WHAT EVERY LAWYER AND BUSINESSPERSON NEEDS TO KNOW 111, 115-18 (1997); Ziomek & McCahill, *supra* note 123, at 64, 66. *But see In re The Prudential Ins. Co. of Am. Sales Practices Litig.*, 975 F. Supp. 584, 616-18 (D.N.J. 1996) (dismissing claims that producers or insurer owed a fiduciary duty to insureds); Anderson & Winslow, *supra* note 9, at 107 n.15; Booth, *supra* note 9, at 1604 n.23, 1605 n.26; Rapp, *supra* note 9, at 194-217 (discussing history of use of fiduciary concepts relative to suitability); *cf.* U.S. SENTENCING GUIDELINE'S MANUAL § 8A1.2 cmt. 3(k)(7)(ii) (1998).

144. *See* RESTATEMENT (SECOND) OF AGENCY § 379 (1958) (requiring exercise of skill and care normally possessed by other professionals); RESTATEMENT (SECOND) OF TORTS § 299A (1965).

145. *See supra* Part II.A. for a discussion of the shingle theory.

146. 29 U.S.C. § 1002(21)(A) (1994). Congress and courts have interpreted fiduciary status in terms of a functional standard based on actual facts and circumstances. *See Harris Trust and Sav. Bank v. Provident Life & Accident Ins. Co.*, 57 F.3d 608, 613 (7th Cir. 1995); 120 CONG. REC. 3977, 3983 (Feb. 25, 1974); 29 C.F.R. § 2510.3-21(c)(1)(1999); *see also* 29 U.S.C. § 1104(a)(1) (1994) (An ERISA fiduciary must "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."); 29 U.S.C. § 1106(b) (1994) (ERISA expressly prohibits fiduciaries from "deal[ing] with the assets of the plan in his own interest or for his own account," or "receiv[ing] any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan."); 29 U.S.C. § 1109(a) (1994) (personal liability results from violation of fiduciary duty); *NLRB v. Amax Coal Co.*, 453 U.S. 322, 329-30 (1981) (An ERISA's fiduciary duty is the most fundamental of his or her duties, and "must be enforced with uncompromising rigidity."); *Schloegel v. Boswell*, 994 F.2d 266, 271-72 (5th Cir. 1993); *Lowen v. Tower Asset Mgmt, Inc.*, 829 F.2d 1209, 1213 (2d Cir. 1987) (This duty, the violation of which subjects a fiduciary to personal liability, is directed particularly at schemes "tainted by a conflict of interest and thus highly susceptible to self dealing."); *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir. 1982) (The requirement that an ERISA fiduciary act "with an eye single to the interests of the participants and beneficiaries."); H.R. CONF. REP. NO. 1280; Interpretive Bulletin 96-1, 29 C.F.R. Part 2509.96-1(d)(1999); RESTATEMENT (SECOND) OF AGENCY § 425(b) (1958); Lisa S. Kahn & Laura M. Metcalfe, *The Broker-Dealer As Fiduciary Under ERISA: Defending Claims by ERISA Plans for Recovery of Their Trading Losses*, in 3 INVESTMENT LAW. 8, 9 (Sept. 1996); *cf.* 29 U.S.C. § 1002(38) (1994) (defining "investment manager"); *Martin v. Feilen*, 965 F.2d 660, 669 (8th Cir. 1992) (discussing accountants providing recommendations regarding transactions and investment advice found to be fiduciaries); *Miller v. Lay Trucking Co.*, 606 F. Supp. 1326 (N.D. Ill. 1985), *aff'd*, 989 F.2d 502 (7th Cir. 1993) (finding insurance agent unintentionally listed as plan administrator and who provided investment and other advice to be a fiduciary); *Brink v. DaLesio*, 496 F. Supp. 1350, 1374-75 (D. Md. 1980) (finding insurance agent to be a fiduciary based on discretionary authority and customer reliance on advice rendered). *See generally* Lowenfels & Bromberg, *supra* note 9, at 1591-92 (discussing how the thin line between investment advice constituting effective control or mere influence is therefore critical to establishing fiduciary status).

147. *See generally* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999); RESTATEMENT (SECOND) OF TRUSTS §§ 170, 173-174, 181, 227, 230-31 (1959).

cern as contractual relations and commission arrangements arguably taint producers' loyalties.¹⁴⁸ The characterization of a producer's fidelity to his or her customer as either that of an ordinary person, or alternatively, that of a fiduciary, can have a dramatic effect on whether a court will apply either a *de novo* or an arbitrary and capricious standard of review.¹⁴⁹

Courts have also struggled to impute a fidelity standard applicable to producers through analogies to the duty of an attorney or accountant to his or her clients.¹⁵⁰ Unfortunately, since neither attorneys¹⁵¹ nor accountants¹⁵² are bound by a clear code of conduct that acknowledges the presumably paramount interests of custom-

148. The present front-end commission structure used by insurance companies has been viewed as a possible source of conflict of interest for producers in fulfilling their duties to customers. See Ronald Duska, *The Ethics of Reward Systems in the Financial Services Industry*, Address at The American College (Aug. 25, 1998) (transcript on file with author). Most insurance companies pay a significant portion of the first year's premium to the producer as a commission with nominal "trail" commissions paid over subsequent years. In contrast, a "leveled" commission structure pays a lower flat commission to the producer over a longer time period. See Kessler, *supra* note 44, at 546; I.M.S.A. Indicator 5.3.b.3, *IMSA ASSESSMENT HANDBOOK*, *supra* note 44, at 78 (using persistency trends used to identify root causes of complaints). See generally Anderson & Winslow, *supra* note 9, at 108 (describing churning cases); Booth, *supra* note 9, at 1603 n.20 (explaining that churning arises in the context of a breach of fiduciary duty for unsuitable recommendations based on the producer's failure to disclose the fact that the reason for the trading is to benefit the broker (through commissions) rather than the customer); *id.* at 1610 (explaining that brokers sometimes recommend riskier securities because they are paid higher commissions). Studies have shown, however, that commissions do not necessarily motivate producers in recommending products to their customers. See Duska, *supra*, at 7 n.10 (citing comments from the 1998 Zicklin Center/Wharton Impact Conference of Ethical Issues in Financial Services). Rather, moral belief in the welfare of others, behavioral controls, and the operative business environment were better determinative factors for producer conduct. *Id.* at 7-8.

149. See *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 115 (1989).

150. See *Kanter v. Dietelbaum*, 648 N.E.2d 1137, 1139-40 (Ill. App. Ct. 1995); *Brown v. Lockwood*, 432 N.Y.S.2d 186 (App. Div. 1980); HOLMES, *supra* note 125; see also Kessler, *supra* note 44, at 541 ("The duties and liabilities of the insurance agent are basically the same as in the case of other professionals. The agent must act in good faith . . . and exercise such reasonable skill and ordinary diligence as may be fairly expected from a person in his situation.").

151. Attorneys are not bound by a professional code to hold their customers' interest paramount. See, e.g., CONN. CT. R.P.C. 1.7. Lawyers may enter into business relations that may be adverse to a customer provided the terms are fair and reasonable to the customer (as disclosed in an understandable written disclosure) and the customer agrees in writing to the same. See CONN. CT. R.P.C. 1.8.

152. See generally CONN. AGENCIES REGS. § 20-280-15c(a), (b) & (e) (1998) (stating that certified public accountants must be independent and act with integrity and objectivity).

ers, such as the Hippocratic Oath,¹⁵³ the exact degree of loyalty of a producer to stand in support of his or her recommendations remains uncertain.

D. *Market Conduct Oversight*

Two of the ways that the life insurance industry has attempted to indirectly control suitability as a form of market conduct include the adoption of broad-based trade practice regulations and the establishment of self-regulatory standards. The core of state regulatory efforts to oversee market conduct is embodied in various forms of the NAIC Model Unfair Trade Practices Act, which has been adopted by most states.¹⁵⁴ The Unfair Trade Practices Act was adopted based on the specific invitation of Congress¹⁵⁵ and "to assure the ouster of [Federal Trade Commission] jurisdiction."¹⁵⁶ The act is notable for many reasons including its breadth and penalties.¹⁵⁷ One commentator also characterized the act as a "code of ethics" for the insurance business.¹⁵⁸ The act indirectly regulates suitability through prohibitions against general misrepresentations,¹⁵⁹ misrepresenting a producer's qualifications to provide investment advice,¹⁶⁰ and defaming another insurer.¹⁶¹

The Insurance Marketplace Standards Association ("IMSA") was established to promote ethical marketplace conduct,¹⁶² thereby

153. For instance, the Oath of Hippocrates setting forth the duties of a physician to patients includes "I will follow that system of regimen which, according to my ability and judgment, I consider for the benefit of my patients, and abstain from whatever is deleterious and mischievous." *BLAKISTON'S NEW GOULD MEDICAL DICTIONARY* (1st ed. 1953).

154. See Unfair Trade Practices Act § 4(A) & (C), V NAIC Model Reg. Serv. 880-2 to -3 (Jan. 1993); see also Unfair Claims Settlement Practices Act § 4(A), V NAIC Model Reg. Serv. 900-2 (July 1991). See generally Lowenfels & Bromberg, *supra* note 9, at 1593 (construing blue sky laws to include suitability).

155. See Unfair Trade Practices Act §1, V NAIC Model Reg. Serv. at 880-1 (Jan. 1993).

156. Legislative History, Unfair Trade Practices Act, *supra* note 154, at 880-19; see JON S. HANSON, *REGULATION OF THE LIFE INSURANCE BUSINESS* 97 (1996).

157. See Unfair Trade Practices Act, *supra* note 154, §§ 6-11. See generally HANSON, *supra* note 156, at 123-25; Burke A. Christensen, *Advertising and Privacy*, in MCGILL'S *LEGAL ASPECTS OF LIFE INSURANCE* 259-60 (Edward E. Graves & Burke A. Christensen eds., 1996).

158. HANSON, *supra* note 156, at 98.

159. See Unfair Trade Practices Act, *supra* note 154, § 4(A).

160. See *id.* § 4(M).

161. See *id.* § 4(C).

162. IMSA ASSESSMENT HANDBOOK, *supra* note 44, at 1. The Securities and Exchange Commission has interpreted NASD suitability standards as being an ethical yardstick for measuring producer conduct. See *In re Burkes*, 51 S.E.C. 356, 360 (1993),

bolstering consumer confidence in the life insurance industry.¹⁶³ Prerequisites to membership include, among other things, certifying that the member thoroughly embraces the importance of suitability by teaching producers about suitability,¹⁶⁴ monitoring whether producers use “needs based” selling concepts to ensure the suitability of their recommendations,¹⁶⁵ prohibiting improper replacements,¹⁶⁶ and discouraging defamatory statements regarding another company.¹⁶⁷

E. *Common Law Detrimental Reliance*

The doctrine of detrimental reliance has also found wide-scale favor in resolving disputes involving presumed ambiguities in connection with the type or scope of insurance sold.¹⁶⁸ There is no reason to suspect that this equitable concept could not be applied, directly or indirectly, to suitability claims. The insured must prove the essential elements of a reliance claim, including that a representation, promise or other act existed,¹⁶⁹ that the maker of the representation expected others to rely on such representation, that the recipient justifiably relied on such representation to his or her detriment, and, as a result, that the recipient/insured suffered some adverse consequence.¹⁷⁰

aff'd 29 F.3d 630 (9th Cir. 1994); Mundheim, *supra* note 9, at 464-66 (noting that the concept of suitability originated, and was intended to remain, as an ethical principle).

163. Robert E. Googins, *IMSA Delivers Consumer Confidence*, GAMA INT'L J. 40 (Nov.-Dec. 1998).

164. See IMSA ASSESSMENT HANDBOOK, *supra* note 44, at 54 (advocating training procedures to ensure that employees understand the suitability requirements).

165. See IMSA ASSESSMENT HANDBOOK, *supra* note 44, at 43-46, 55 (describing practices that companies should follow to monitor their sales employees).

166. See IMSA ASSESSMENT HANDBOOK, *supra* note 44, at 62.

167. IMSA Principle 3 requires that producers and insurers refrain from disparaging competitors. IMSA ASSESSMENT HANDBOOK, *supra* note 44, at 65.

168. ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW § 6.5(a) (Practitioner's ed. 1988). For a general discussion of the doctrine of reasonable expectations, see Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring The Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151 (1981); Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823 (1990); Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323 (1986); Peter N. Swisher, *A Realistic Consensus Approach to the Insurance Law Doctrine of Reasonable Expectations*, 35 TORT & INS. L.J. 729 (2000).

169. This may take the form of an express or implied statement that a recommendation is suitable. Producers may be a source of exposure to manufacturers especially where customer expectations are not managed properly and a customer is simply led to a single product. See ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW § 6.5(c) n.4 (Practitioner's ed. 1988).

170. See Davidson v. Wilson, 973 F.2d 1391, 1400 (8th Cir. 1992); Myers v. Finkle,

III. THE SEARCH FOR A UNIVERSAL PARADIGM

The absence of a universal suitability paradigm is a problem for customers and producers/manufacturers¹⁷¹ alike. As the preceding discussion indicates, suitability standards may depend on whether the customer is vulnerable, astute, or rich. Different standards apply if the product recommended is a traditional product, variable product or a replacement product. The purchase of a variable product from within a bank is subject to one set of rules that have no relevance to the purchase of the very same product from the broker-dealer next door. The sale of a traditional product is subject to altogether different procedures depending on whether it is sold at a bank branch, the broker-dealer next door, the law firm around the corner, or the insurance agency across town. These rules also change when crossing state lines and may have absolutely no application to products online.

Compliance with suitability laws, regulations, and regulators' biases¹⁷² also presents a formidable challenge for supervisors¹⁷³ and

950 F.2d 165, 167 (4th Cir. 1991); *Molecular Technology Corp. v. Valentine*, 925 F.2d 910, 918 (6th Cir. 1991); *Bruschi v. Brown*, 876 F.2d 1526, 1529 (11th Cir. 1989); *Kennedy v. Josephthal & Co.*, 814 F.2d 798, 804 (1st Cir. 1987); *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1516 (10th Cir. 1983). The viability of a § 10(b) unsuitability claim requires the plaintiff to prove:

- (1) that the securities purchased were unsuited to the buyer's needs; (2) that the defendant knew or reasonably believed the securities were unsuited to the buyer's needs; (3) that the defendant recommended or purchased the unsuitable securities for the buyer anyway; (4) that, with scienter, the defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information) relating to the suitability of the securities; and (5) that the buyer justifiably relied to its detriment on the defendant's fraudulent conduct.

Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993).

171. See generally LIFE INS. & ANNUITIES MODEL REG. §§ 4-7, 8(D), III NAIC Model Reg. Serv. 613-5 to -10 (Nat'l Ass'n Ins. Comm'rs) (July 2000) (oversight duties and penalties); LIFE INS. DISCLOSURE MODEL REG. § 2(A), III NAIC Model Reg. Serv. 580-3 to -6 (Nat'l Ass'n Ins. Comm'rs) (Oct. 2000); NTM 99-35, *supra* note 11 (discussing the applicability of suitability guidelines to wholesalers); *District Directors Securities Conference Open Forum*, 13.2 REG. & COMPLIANCE ALERT 13 (1999) available at <http://www.nasdr.com> (stating that "firms share responsibility for implementing supervisory procedures focused on suitability"); *The Obligations of Underwriters, Brokers and Dealers in Distributing and Trading Securities, Particularly of New High Risk Ventures*, Exchange Act Release Nos. 33-5275, 34-9671 (July 26, 1972), *reprinted in* 2 Fed. Sec. L. Rep. (CCH) ¶ 4506B, at 4058-59 (Mar. 16, 1988) ("[V]iolations of suitability rules may involve fact patterns which also would constitute violations of . . . securities acts."). See *infra* notes 183-85 and accompanying text for a discussion of supervisory problems with regard to producers.

172. See Paul Royce, Director, Variable Insurance Products: The Challenges of a New Millennium, Keynote Address Before the ALI-ABA Conference on Life Insur-

employees.¹⁷⁴ A well-founded fear of regulatory¹⁷⁵ and civil expo-

ance Company Products: Current Securities, Tax, ERISA, and State Regulatory Issues (Oct. 19, 2000) available at <http://www.sec.gov/news/speech/spch409.htm>; Paul Roye, Director, Understanding the Securities Products of Insurance Companies, Keynote Address Before the Practicing Law Institute (Jan. 9, 2001), available at <http://www.sec.gov/news/speech/spch455.htm>; Jackson, *supra* note 16, at 348 (vague standards are subject to opportunistic enforcement). The Office of Compliance Inspections and Examinations ("OCIE") established by the Securities and Exchange Commission oversees market conduct and sales practices. In late December, 1996, the SEC's Division of Enforcement and OCIE initiated inquiries focusing on replacement activities involving variable products with a particular emphasis on the suitability of premium financing (i.e., using existing cash values to fund premium obligations for replaced products). This inquiry led to an enforcement action under Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 involving churning. *In re Parkins*, Sec. Exchange Act Release No. 43336 (Sept. 25, 2000), available at 2000 WL 1375473.

173. See Exchange Act § 15(b)(4)(E), 4 Fed. Sec. L. Rep. (CCH) ¶ 25,051, at 18,084 (Dec. 12, 1990) (providing broker-dealer sanctions for failure to reasonably supervise others so as to prevent violations of governing laws and regulations); see also Exchange Act § 15(b)(6)(A)(i), 4 Fed. Sec. L. Rep. (CCH) ¶ 25,055, at 18,085-6 (Aug. 14, 1996) (providing for suspension, bar, or censure for violating supervisory obligations). See generally *In re First Secs. Corp.*, 40 S.E.C. 589, 592-93 (1961) (spot-checking required to identify unsuitable sales); *In re Boren & Co.*, 40 S.E.C. 217, 226 (1960) (stating that sales personnel must be actively supervised for suitability). Securities supervision is affected through qualified principals. See NASD Membership & Registration Rules 1021, 1023, NASD Manual & Notices to Members (1998), available at <http://secure.nasdr.com/wbs/NETbos.dll?RefShow?ref=NASD4;&xinfo=/goodbye.htm>; Supervision, NASD Conduct 3010(a)(2), (4)-(6), NASD Manual & Notices to Members (1998), available at <http://secure.nasdr.com/wbs/NETbos.dll?RefShow?ref=NASD4;&xinfo=/goodbye.htm>; N.Y.S.E. Rule 342(b)(1), N.Y.S.E. Const. & Rules (CCH) ¶ 2342, at 3585 (Nov. 1993); NTM 00-44, *supra* note 10, at 301 (review of customer information); NASD Provides Guidance on Supervisory Responsibilities, NASD Notice to Members 99-45, June 1999, 1999 WL 33176539 (National/Federal); NASD Regulation Provides Interpretive Guidance on Registration Requirements, NASD Notice to Members 99-49, June 1999, 1999 WL 33176543 (National/Federal); NASD Regulation Requests Comment on Requiring Chief Compliance Officers To Be Registered, NASD Notice to Members 99-51, June 1999, 1999 WL 33176545 (National/Federal). See generally *In re Chancellor Capital Mgmt., Inc.*, Investment Advisers Act Release No. IA-1447, 57 S.E.C. Docket 2204 (Oct. 18, 1994), available at 1994 WL 570098; *In re Feldman*, Exchange Act Release No. 33-7014, 55 S.E.C. Docket 9 (Sept. 20, 1993), available at 1993 WL 370958; *In re Gutfreund*, Exchange Act Release No. 34-1554, 52 S.E.C. Docket 2849 (Dec. 3, 1992), available at 1992 WL 362753; Simon M. Lorne, Administrative Actions Against Lawyers Before the SEC, Address at the Annual Meeting of the American Bar Association Business Law Section (Aug. 1995); Mary L. Schapiro, Remarks to the National Association of Securities Dealers, Inc. (Oct. 5, 1993) (discussing liability of compliance officers and attorneys for failure to supervise).

174. See generally Stano & Wilkerson, *supra* note 124; Pac. Mut. Life Ins. Co. v. Haslip, 499 U.S. 1, 13-15 (1991) (insurer received notices and complaints of fraud); IMSA ASSESSMENT HANDBOOK, *supra* note 44, at 84. In life insurance companies, supervisory responsibilities can be horizontally and vertically stratified. Intra-departmental supervision of needs analysis and use of fact finders can also be broken down to functional categories such as direct/primary responsibility (producers, field coordinators

sure¹⁷⁶ drives the development of policies and procedures intended to ensure supervision of producers conducting suitability analyses. These policies and procedures necessitate a commitment to the procurement of supervisory staff capable of meeting with producers on a meaningful basis¹⁷⁷ and effectively overseeing compliance.¹⁷⁸

and underwriting), process management (field managers and home office middle managers), oversight (distribution management), monitoring/auditing (compliance and audit) and interpretation/advice (law department). Unlike their securities counterparts, life insurance supervisors need not demonstrate their expertise by passing mastery examinations. Cf. Supervision, NASD Conduct Rule 3010(a)(6), *supra* note 173; Registration, NASD Membership and Registration 1021, 1022, 1070, *supra* note 173.

175. See, e.g., *In re* Dist. Bus. Conduct Comm. v. Cruz, No. C8A930048, 1997 WL 33101218 (Nat'l Bus. Conduct Comm. Oct. 31, 1997).

176. See Bridget O'Brian, *Prudential Fined \$20 Million by NASD over Its Sales of Variable Life Insurance*, WALL ST. J., July 9, 1999, at C1. See generally NTM 01-23, *supra* note 11 (excessive trading and churning are examples of unsuitable recommendations).

177. Supervisors are required to conduct periodic personal meetings with all producers no less frequently than annually, and preferably on an unannounced basis. See NASD Conduct Rule 3010(a)(8) & (c), *supra* note 173 (annual inspection of all OSJs and cyclical examinations of branch offices). See generally *In re* NYLife Secs. Inc., Exchange Act Release No. 34-40459, 68 S.E.C. Docket 103 (Sep. 23, 1998), available at 1998 WL 646712 (audit customer files); *In re* Royal Alliance Assocs., Exchange Act Release No. 34-38174, 63 S.E.C. Docket 1606, (Jan. 15, 1997), available at 1997 WL 13023 (failure to effectively supervise for reasons which included ineffective on-site audit protocol); *In re* Consol. Inv. Servs., Inc., Exchange Act Release No. 34-36687, 61 S.E.C. Docket 19 (Jan. 5, 1996), available at 1996 WL 20829 (compliance questionnaires). This inspection must determine whether the agency and its personnel, whether centralized or detached, are complying with company policies and procedures and with the requirements of applicable laws and regulations. The purpose of such meeting is to, among other things, examine files and records for examples or patterns of possible problematic sales or solicitations, to provide an opportunity for producers to ask questions and receive guidance regarding compliance concerns, and to present regulatory-, policy- and compliance-related issues. See NASD Conduct Rule 3010(c), *supra* note 173. See generally Unfair Trade Practices Act § 4(J) V NAIC Model Regulation Service at 880-6 (Jan. 1993) (records requirements).

178. See IMSA Princ. 6, Question 6.1, Indicator 6.1.a.2, and Question 6.2, Indicators 6.2.a.7 & 6.2.b.3, IMSA ASSESSMENT HANDBOOK, *supra* note 44, at 81, 84; FEDERAL SENTENCING GUIDELINE MANUAL §§ 8A1.2 cmt. 3(k), 8C2.5(f) (stating that a reduction in culpability score is based upon the presence of an "effective program to prevent and detect violations of law"); see also *In re* Consol. Inv. Servs., Inc., 52 S.E.C. 582 (1996) (providing analysis of the standards of reasonableness under the section 15(b)(4)(E) safe harbor). In 1992, the Committee of Sponsoring Organizations of the Treadway Commission developed a benchmark for effective internal control systems that included five components of control: environment, risk assessment, control activities, information and communication, and monitoring. William C. Jennings & Peter C. Sutherland, *Internal Control Systems Help Insurers Reduce Risk*, BEST'S REV. LIFE-HEALTH INS. ED. 72 (Jan. 1996), available at 1996 WL 8831049. But see FEDERAL SENTENCING GUIDELINE MANUAL, *supra*, § 8C2.5(f) (stating that a rebuttable presumption of ineffectiveness of compliance with the program exists where high level personnel participate in violations or where, after becoming aware of an offense, the

Manuals must be periodically updated.¹⁷⁹ Training,¹⁸⁰ including ethics awareness¹⁸¹ and needs based selling,¹⁸² must also occur. However, the very existence of these policies and procedures creates exposure in the absence of conscientious monitoring.

The challenge of adequately supervising producers becomes even more stringent as distribution channels¹⁸³ become more diffuse through detached¹⁸⁴ and independent producers and brokers.¹⁸⁵ This contrasts with an environment in which all producers

organization unreasonably delayed reporting the offense to appropriate governmental authorities).

179. See NASD Conduct Rule 3010(b)(4), NASD Manual & Notices to Members (1999), available at

<http://secure.nasdr.com/wbs/NETbos.dll?Refshow?ref=NASD4;&xinfo=/goodbye.htm>.

180. See NASD Membership and Registration Rules, NASD Manual & Notices to Members ¶ 1120 (May 1999) available at

<http://secure.nasdr.com/wbs/NETbos.dll?Refshow?ref=NASD4;&xinfo=/goodbye.htm>;

IMSA Princ. 2, Codes C-F, IMSA ASSESSMENT HANDBOOK, *supra* note 44, at 54-59.

181. See IMSA Princ. 1, Code C & IMSA Princ. 6, Code A, IMSA ASSESSMENT HANDBOOK, *supra* note 44, at 48, 81.

182. IMSA Princ. 1, Code A, IMSA ASSESSMENT HANDBOOK, *supra* note 44, at 42.

183. For the purposes hereof, "distribution channels" refers to the various ways that manufacturers use producers to solicit and sell their products. For instance, manufacturers may distribute their products through brokers or career agents, or they could distribute through channels based on the type of product or geographic region. The life insurance industry had traditionally used an agency system to distribute its products. Under this system, the manufacturer's "home office" would supervise the activities of "field" offices or agencies through an agency manager. In the current environment, however, manufacturers have either abandoned or diminished their dependence on the agency system. These circumstances affect the ability of home office management to monitor the activities of field producers.

184. As used herein, the term "detached producers" refers to producers who sell products from locations other than agencies established by manufacturers or perhaps the home office of the manufacturer (for example, sales from a producer's home). Proximity of supervisors to the producers that they supervise is one measure of the effectiveness of supervision. See generally NASD Notice to Members 98-38, NASD Reminds Members of Supervisory and Inspection Obligations (May 1998) (stating that firms should consider the number and location of its registered principals in terms of its capability to effectively supervise unregistered office personnel); NASD Notice to Members 99-45, NASD Provides Guidance on Supervisory Responsibilities, at 300 (Jun. 1999) (discussing one-on-one supervision requirements); NTM 00-44, *supra* note 10, at 303. IMSA has likewise endorsed a supervisory system modeled on NASD requirements. See *supra* note 173 and accompanying text for a discussion of this supervisory system.

185. Manufacturers typically have less control over "independent producers" (i.e., producers appointed to represent many manufacturers). Manufacturers "appoint" producers to sell their products in a particular state. Independent producers may also be contractually bound to adhere to that manufacturer's particular solicitation standards as a result of being appointed. Such contractual arrangements may allow the producer and manufacturer to negotiate how supervision will be affected. See IMSA Princ. 6, Code B cmts.; Question 6.2, Indicator 6.1.a.4, IMSA ASSESSMENT HANDBOOK,

work in centralized locations under the watchful eyes of their supervisors. Supervisory mandates based on a centralized distribution concept could have the effect of forcing manufacturers to decide whether the cost of compliance is disproportionate to the cost associated with under-supervising decentralized producers. Thus, manufacturers face the difficult question of trying to appease regulators by adopting unenforceable or unenforced policies and leaving the impossible task of enforcement to ill-equipped and under-supported compliance departments. One possible solution to this dilemma could be to adopt an overarching suitability mission statement.

One simplistic mission statement could be that producers and manufacturers must work together to “[s]ell the right policy to the right prospect in the right way.”¹⁸⁶ Criteria used to fulfill this mission then would depend on making certain decisions as an industry and at each level along the distribution path of product solicitation. First, a determination must be made whether suitability is an outcome-oriented *objective* to later measure the efficacy of advice or a *process* that can be reliably measured and monitored. Once that is determined, other issues should be resolved. These include whether the rule should protect customers from producers/manufacturers or attempt to level the playing field among producers and on what basis appropriate regulatory oversight should be established.

A. *Should Suitability Be an Outcome- or a Process-Oriented Objective?*

The development of any model suitability standard depends on

supra note 44, at 83-84. The growing use of independent producers caused great difficulties for insurance companies seeking IMSA membership under its original code. The initial code placed many oversight responsibilities on manufacturers. *See, e.g.*, IMSA Princ. 6, Code B cmt. 1, IMSA ASSESSMENT HANDBOOK, *supra* note 44, at 83 (stating that before allowing an independent producer to sell its products, the insurer ascertains the good character, business repute, qualifications, and training of the producer in accordance with IMSA Principle 2, Code A); NASD Conduct Rule 3010(e), NASD Manual (CCH) ¶ 3010, at 4834 (Nov. 1999); IMSA Princ. 2, Code A, IMSA ASSESSMENT HANDBOOK, *supra* note 44, at 51. *See generally In re Mabon*, Mugent & Co., 47 S.E.C. 862, 867 (1983) (discussing supervision of sales activities); NTM 97-19, NASD Regulation and New York Stock Exchange Memorandum Discusses Sweep Report and Provides Guidance on Heightened Supervision Recommendations (Apr. 1997).

186. Kessler, *supra* note 44, at 545. *See generally* KREITNER, *supra* note 50, at 111 (stating that doing things right the first time is a critical component of total quality management).

whether suitability is to be evaluated as a process, a process and structure, or measured by outcome.

1. Process Orientation

A process-oriented approach would attempt to ensure that as long as a reliable¹⁸⁷ process was used to determine the appropriateness of a recommendation, neither the producer nor the manufacturer would be held liable if the results failed to meet the customer's expectations. A process orientation should require an adequate "top-down" commitment to the process, and a willingness to discipline any non-compliant producer. This approach also depends on a series of accepted "norms" which would need to be established in the financial services industry for each manufacturer and producer. This approach could be criticized, however, on the basis that the use of norms stifles autonomy and creativity. Another criticism of a process orientation is that an unsatisfied customer may have no recourse against a producer who followed the process of determining the suitability of their recommendations.

2. Process and Structure Orientation

An alternative to a pure process orientation would be to establish a process and structure orientation. This type of orientation would incorporate all of the process considerations noted above, but also add the concept of checks and balances through the inclusion of various hierarchical forms of supervision. The NASD approach to broker-dealer supervision generally embraces this type of approach.¹⁸⁸ For instance, the broker-dealer would first adopt a compliance code that addresses suitability as an important consideration.¹⁸⁹ Product manufacturers could also develop their own internal requirements for confirming the suitability of recommendations in connection with new product sales and replacements.¹⁹⁰ Supervisory chains would then be deployed to oversee that these commandments are complied with and that repercussions follow from non-compliance¹⁹¹ as suggested by the NASD and IMSA.¹⁹² One drawback to this approach is that it might not be appropriate for

187. See generally KREITNER, *supra* note 50, at 109.

188. See *supra* notes 173-74 and accompanying text for a discussion of the NASD supervisory structure.

189. See *supra* note 178.

190. See *supra* notes 95-96, 177.

191. See *supra* note 178.

192. See *supra* notes 177-82 and accompanying text.

new or novel distribution channels. For example, a hierarchical supervisory structure may be alien to banks that have historically given platform customer service representatives the exclusive authority to oversee their own suitability analysis.

3. Outcome Orientation

Another alternative would be to develop a standard based entirely on outcomes. Under such an approach, the appropriate inquiry would be whether the customer was harmed in any way by the recommendation. Obviously, public confidence could be bolstered by such a standard. There are good reasons, however, why outcomes should not be the primary measure of suitability. First, the desired "outcome" cannot be discovered until it is too late for the producer or manufacturer to do anything about it. Even if producer and customer expectations appear to be aligned at the time of sale (i.e. through commissions for the producer and the prospect of positive returns for the customer), inherent incongruencies exist since the customer alone will suffer from subsequent performance disappointment. Moreover, an outcome orientation cannot discern the "trusting sweet widow" from the "greedy old lady." As discussed above, it could be argued that we have already migrated to an outcome orientation. However, if outcomes continue to be a basis to judge suitability, producers and manufactures will be and remain as investment intermediaries guaranteeing investment results. As a result, the cost associated with correcting the outcome of recommendations will continue to factor into product prices that will then be cross-subsidized by all other customers.

Second, an outcome orientation does not recognize the importance of product costs and their impact on how customers may make their investment decisions.¹⁹³ A broader range of ostensibly suitable products usually exists than a customer may be able to afford. The customer's value perception of whether any alternative product is "affordable," "affordable with strain," or "unaffordable" may lead to vastly different outcomes. These perceptions are also dependent upon the customer's sense of urgency at the moment of solicitation. For instance, most people would say that they would buy as much insurance as possible if they thought that they would die tomorrow. If they thought that they might live just a little bit

193. See generally *DIRECT RESPONSE*, *supra* note 16 (stating that sixty-eight percent of respondents indicated that cost of insurance was the most important factor in their buying decision).

longer, however, this assumption may no longer hold true. A pure outcome orientation that includes this, and other subjective customer decisions, therefore leads the financial services industry no further than their present stead.

On the other hand, it can be argued that an outcome orientation may be best suited for egregious cases involving outright fraud and material misrepresentations. Accordingly, fact patterns involving these factors should continue to frame the "easy" cases involving suitability.

B. *Whom Should Suitability Protect?*

Not *all* customers may need protection against their own investment decisions. For instance, many securities regulators acknowledge that "sophisticated" customers seem to be able to fend for themselves.¹⁹⁴ In an environment where a great deal of financial data is now readily available in the public domain, should *all* other customers be entitled to second-guess their decisions? "Boiler-room" sales cases involving high pressure tactics used by some unscrupulous stock brokers may have led to the establishment of a sympathetic "little old widow" benchmark. In reality, the reasonably prudent person would make a more reliable standard.¹⁹⁵ This lowest common denominator approach is therefore flawed because those people who, despite disclosures, still cannot adequately fathom the nature of their investment would require an unlimited number of other protections against a producer and themselves.¹⁹⁶

C. *Leveling the Playing Field Among Producers*

The present environment, where different producers are subject to different suitability duties, creates an unfair advantage to less-regulated producers. The "best advice" standard adopted in the United Kingdom presents one model for leveling the playing field among these different types of producers. English solicitation

194. See *supra* Part I.B for a discussion of the sophisticated securities customer.

195. See generally Marc A. Rodwin, *Consumer Protection and Managed Care: Issues, Reform Proposals and Trade-Offs*, 32 HOUS. L. REV. 1319, 1363-66 (1996) (stating that the Federal Trade Commission's authority to prohibit "unfair" practices is premised on a "reasonable" purchaser standard is appropriate relative to insurance, securities and managed care).

196. See generally *Csordas v. Smith Barney, Harris, Upham & Co.*, No. CI91-1764, 1992 WL 426460, at *1 (Fla. Cir. Ct. July 16, 1992) ("[T]he broker must explain to the customer the risks of purchasing a security in such a way that would enable the customer to relate the risks of the transaction to his risk threshold and thus make the independent determination himself of whether or not to purchase the security.").

regulations were developed in the early 1980s following a series of market conduct scandals.¹⁹⁷ The Financial Services Act ("Code") of 1986¹⁹⁸ led to the establishment of self-regulatory organizations.¹⁹⁹ The United Kingdom regulator, the Financial Services Authority, and its predecessor, LAUTRO (Life Assurance and Unit Trust Regulatory Organisation), have imposed significant fines and penalties for breaches of the Code.²⁰⁰

The "Conduct of Business Rules"²⁰¹ were intended to "promote high standards of integrity and fair dealing" by representatives while interacting with customers, and to "make proper provision for requiring an authorised person to act with due skill, care, and diligence"²⁰² The Code addresses producer conduct with a potential customer. The Financial Services Authority also introduced the concept of "polarisation," which means that any sales representative must either be independent (i.e., a broker in the United States) and be able to demonstrate independence ("Independent Financial Advisers")²⁰³ or, alternatively, must be a representative of only one company, selling only products of his or her host company (so-called "tied advisors" or "appointed representatives").²⁰⁴ This allegiance disclosure also exists, for example, for Connecticut real estate brokers or salespersons who must disclose their affiliation with either the property buyer or seller²⁰⁵ in a signed written statement before the first personal meeting with prospects.²⁰⁶

U.K. regulations apply a "best advice" standard only to inde-

197. See generally ROSS JONES, UK REGULATION (LIMRA International 1997) (discussing the development of insurance brokers regulations in the United Kingdom).

198. Financial Services Act, 1986, ch. 60 (Eng.).

199. *Id.* § 48; see also *id.* §§ 10, 15 (1986); JONES, *supra* note 197, at 6.

200. See, e.g., Alison Smith, *Life Insurers Face Jump in Fines*, THE FINANCIAL TIMES, Apr. 3, 1993 (stating that fines expected to start at more than £200,000); Carol O'Leary, *UK: Insurers Fail Lautro Test*, LONDON DAILY TELEGRAPH, July 19, 1994 (noting that Norwich Union suspended all its 800 insurance salesmen in response to being fined £325,000, including costs); Robert Miller, *Life Insurers Face Swinging Fines*, LONDON TIMES, Oct. 6, 1994 (stating that some of Britain's leading life insurance companies have been subject to fines, which together with costs, would top £500,000).

201. Financial Services Act, 1986, ch. 60, § 48 (Eng.).

202. *Id.* sch. 8, §§ 1-2.

203. FINANCIAL SERVICES AUTHORITY GUIDE TO FINANCIAL ADVICE 13 (May 2000) (discussing two main types of financial advisers), available at <http://www.fsa.gov.uk/pubs/index-chrono-2000.html> [hereinafter FSA GUIDE].

204. *Id.*

205. CONN. GEN. STAT. § 20-325d (2001).

206. *Id.*

pendent financial advisers.²⁰⁷ These representatives must take into account all aspects of a customer's circumstances when giving advice.²⁰⁸ Customer information and recommendations are typically recorded on a "fact find."²⁰⁹ The independent financial adviser must only recommend a product that is suitable, taking into account the customer's circumstances.²¹⁰ Independent financial advisers must not recommend any contract if none is suitable—a closest fit is not acceptable.²¹¹ The independent financial adviser must also reasonably believe that there is no other investment or product that is likely to secure the customer's investment objectives "more advantageously."²¹²

The U.K. customer must be given sufficient information to make an informed decision.²¹³ For example, the independent financial adviser must give a "key features" disclosure containing a general description of the particular product that is being recommended, including charges, policy benefits, and any associated risks.²¹⁴ This disclosure is intended to be a "short and punchy synopsis of the product which is easy to read and capable of being understood by the investor."²¹⁵ Commissions or other remuneration must also be disclosed upon request, or, in any case, prior to completion of the application.²¹⁶ Finally, a "reason why" letter pro-

207. See PERSONAL INVESTMENT AUTHORITY LIMITED, PIA RULE BOOK, ADOPTED SIB (CONDUCT OF BUSINESS) RULE, § 5.02 (June 1997) [hereinafter PIA RULE BOOK]; Robert W. Stein, *Product Suitability Looms As Market Conduct Hurdle*, 97 BEST'S REV. LIFE-HEALTH INS., Dec. 1, 1996, available at 1996 WL 13935485; Hill Gallagher, *Learning from the U.K.'s Disclosure Experience*, NAT'L UNDERWRITER LIFE & HEALTH-FIN. SERVICES., Feb. 3, 1997, available at 1997 WL 9318794 ("[I]f one company is getting a disproportionate share of an agent's business, that agent will be required to demonstrate that 'best advice' was given in cases involving that insurer").

208. See PIA RULE BOOK, *supra* note 207, § 3.01 (May 1995).

209. JONES, *supra* note 197, at 9. A fact finding is not required for unsolicited sales. *Id.*

210. See Financial Services Act, 1986, ch. 60, § 4 (Eng.); PIA RULE BOOK, *supra* note 207, §§ 5.01-5.02.

211. See Stein, *supra* note 207.

212. PIA RULE BOOK, *supra* note 207, § 5.02(1); *cf. id.* § 5.03.

213. See Financial Services Act, 1986, ch. 60, § 7 (Eng.).

214. FSA GUIDE, *supra* note 203, at 13. The Key Features Disclosure must include projected benefits illustrations, projected surrender values over the first five years, and subsequent quinquennial years to maturity, a description of the effects of deductions and an overall description of the policy. See KPMG PEAT MARWICK, INSURANCE BULLETIN LIFE ASSURANCE PRODUCT AND COMMISSION DISCLOSURE -THE NEW RULES 2 (June 1994).

215. TILLINGHAST INSURANCE UPDATE, NEW PRODUCT DISCLOSURE RULES, 2 (July 1, 1994).

216. See Financial Services Act, 1986, ch. 60, § 5 (Eng.); PIA RULE BOOK, *supra* note 207, § 5.13; see also KPMG PEAT MARWICK, *supra* note 214, at 3; Gallagher, *supra*

vides full details of the advantages and disadvantages of any potential replacement must be given no later than the cancellation notice.²¹⁷

While the U.K. best advice system led to criticism,²¹⁸ there is an appeal to forcing an allegiance disclosure at the onset of solicitation activities. Such a standard is also generally consistent with the existing duties of U.S. property insurance brokers to find the best available coverage²¹⁹ and the overall recognition in U.S. agency law of the loyalty of a broker as compared to an agent.²²⁰

D. *Who Should Oversee Suitability?*

The concept of functional regulation within the Gramm-Leach-Bliley Act sets one possible framework for the consolidation of regulatory oversight.²²¹ The United Kingdom best advice system provides an alternative model based on a centralized self-regulatory authority overseeing sales. By way of comparison, the Connecticut Department of Consumer Protection oversees real estate agent discipline regardless of the type of recommendation involved.²²² Similarly, quality oversight deployed by Managed Care Organizations (MCOs) provides another possible structure for regulating the efficacy of recommendations.²²³

note 207 (noting that disclosure of acquisition costs rather than commissions would be more meaningful to consumers).

217. KPMG PEAT MARWICK, *supra* note 214, at 2; *see also* Financial Services Act, 1986, sch. 8, § 5 (Eng.).

218. NANCY D. BOYNTON, LIMRA INTERNATIONAL INC., *BEYOND THE WAVE – MARKET CONDUCT IN A MARKET SEA CHANGE* 6-8 (1996) (stating that in the year in which disclosure regulations first went into effect, the number of new policies sold in the U.K. dropped to the lowest point since the 1970's). *See generally* Gallagher, *supra* note 207 (stating that the cost of doing business by independents increased as syndicates charged fees to perform due diligence on possible product recommendations).

219. *See generally* HOLMES, *supra* note 125, at 423 (noting that once a heightened standard of care is found to exist, the producer may have a duty to procure the best available coverage); *Darner Motor Sales Inc. v. Universal Underwriters Ins. Co.*, 682 P.2d 388, 403 n.14 (Ariz. 1984) (“[C]ompany agents’ are held to a somewhat lower standard than ‘independent agents’ . . .”).

220. *See* Eglin & Rogers, *supra* note 125, at 113-15; HOLMES, *supra* note 125, at 425-37.

221. Gramm-Leach-Bliley Act, Pub. L. 106-102, 133 Stat. 1338 (1999) (providing that insurance activities of any persons shall be “functionally” regulated by the states); *see also* Jackson, *supra* note 16, at 387-98 (analyzing functional regulation).

222. *See* CONN. GEN. STAT. §§ 20-311a(a), b(2) (1999).

223. The health field has historically been concerned about the quality of its services to patients. *See* David Blumenthal, *The Origins of the Quality-of-Care Debate*, 335 *NEW ENG. J. MED.* 1146 (1996); David Blumenthal, *Quality of Care – What Is It?*, 335 *NEW ENG. J. MED.* 891 (1996); Robert H. Brook et al., *Measuring Quality of Care*, 335

One particular appeal of the MCO system may lie in its deference to professional peers to assess the effectiveness of utilization review programs.²²⁴ The MCO industry has also submitted to private accrediting to increase consumer confidence.²²⁵ These quality assurance initiatives, bolstered by the recent passage of a “consumer bill of rights,”²²⁶ could provide significant inspiration to the financial services industry. Applying this approach, there are opportunities for IMSA to model itself after the National Committee for Quality Assurance²²⁷ or similar self-regulated credentialing authorities. These initiatives could also be combined with peer suitability review²²⁸ based on a consumer bill of rights, thereby ensuring both a commitment by producers to conduct an adequate suitability analysis and a consumer’s obligation to assume accountability for becoming as familiar as possible with the consequences of his or her investment decisions.

NEW ENG. J. MED. 966 (1996); Mark R. Chassin, *Improving the Quality of Care*, 335 NEW ENG. J. MED. 1060 (1996); David Orentlicher, *Paying Physicians More to Do Less: Financial Incentives to Limit Care*, 30 U. RICH. L. REV. 155, 156-58 (1996). The relatively recent advent of managed care organizations (MCOs) has accentuated the conflict between patient care and cost containment measures. The service provider in these organizations is presently challenged to defend both the efficacy and the cost effectiveness of his or her advice.

224. See, e.g., S.D. CODIFIED LAWS § 58-17C-41 (Michie 1999).

225. See sources cited *supra* note 217.

226. See Advisory Commission on Consumer Protection and Quality in the Health Care Industry, *Consumer Bill of Rights and Responsibilities*, Report to the President of the United States (Nov. 1997), available at <http://www.hcqualitycommission.gov/cborr/>.

227. The National Committee for Quality Assurance (NCQA) is a private, not-for-profit organization dedicated to assessing and reporting on the quality of managed care plans. The NCQA accredits MCOs through a voluntary program. NCQA currently uses Health Plan Employer Data and Information Set (HEDIS), a standardized performance measurement matrix, to ensure that customers have certain information needed to compare MCOs. HEDIS 2000 contains fifty-six measures, seventeen of which are dedicated to effectiveness of care. Diagnostics are considered as well as mechanisms used to ensure consistent review. See, e.g., S.D. CODIFIED LAWS §§ 58-17C-37(2), (4), (5) (2000). The utilization review program itself is also periodically evaluated to assure ongoing efficiency and continued improvement. See, e.g., S.D. CODIFIED LAWS § 58-17C-38 (2000). It is interesting to note that the self-evaluation aspects contemplated by this process represented a significant impediment to the life insurance industry’s acceptance of the IMSA self-evaluation process. The adoption of a limited privilege for such assessments in states such as Illinois represents the type of protections thought to be so essential in the life insurance industry. See, e.g., 215 ILL. COMP. STAT. 5/155.35 (2001).

228. See generally Mark A. Hall & Gerard F. Anderson, *Health Insurers’ Assessment of Medical Necessity*, 140 U. PA. L. REV. 1637, 1674-81 (1992) (stating that a de novo review standard would be preferable to ex post judicial assessments).

E. *Managing Customer Expectations*

Whatever standard emerges, or even if no standard emerges, producers should be encouraged to manage customer expectations at the time of solicitation and, ideally, throughout the duration of their relationship. Managing customer expectations is a multi-step process that starts with a producer matching his or her knowledge of the customer's needs, aspirations, and risk tolerance with his or her presumably thorough knowledge of his or her preferred manufacturer's products, and others available in the marketplace.²²⁹

Suitability is, and will remain, a process of finding a range of products that may satisfy a customer's needs and objectives to varying degrees. Producers would therefore be well served by having the confidence of their convictions and presenting these alternatives in a balanced manner that would allow customers to evaluate the products before making any purchase.

Managing customer expectations through this form of informed consent²³⁰ is not necessarily intended to totally eliminate possible suitability claims. Reasonably prudent customers should bear the ultimate financial consequences when their educated investment decisions turn out other than expected.²³¹ The threat of

229. This point is exemplified by NTM 99-35, *supra* note 11, and NTM 00-44, *supra* note 10, at 301-02, which both warn producers that they must have a thorough knowledge of the specifications of each variable product recommended. IMSA Principle 2, Code D also requires that producers have "adequate knowledge" of products and their operation. IMSA ASSESSMENT HANDBOOK, *supra* note 44, at 56. *See generally* Hanly v. SEC, 415 F.2d 589, 595-96 (2d Cir. 1969) (stating that for a registered representative to have the requisite reasonable basis for believing that a particular security is appropriate for any investor, the broker-dealer must have performed due diligence on the security); *In re* F. J. Kaufman & Co., 50 S.E.C. 164 (1989) (requiring producers to know their "transaction" as well as their customer); Wang v. Allstate Ins. Co., 592 A.2d 527 (N.J. 1991) (quoting Rider v. Lynch, 201 A.2d 561 (N.J. 1964)).

230. *See* NTM 00-44, *supra* note 10, at 302-03; NASD Investors' Best Practices (unsuitability), available at http://www.nasdr.com:80/4300_page_2.htm.

231. *See* Booth, *supra* note 9, at 1605.

[T]he question remains how to distinguish cases of genuine broker misbehavior from cases in which the investor has lost fair and square. After all, investing is risky business and, therefore, investors should expect to lose sometimes. A broker cannot be expected to insure success. Thus, mere mistakes of judgment should not suffice to allow investor recovery even if the requisite relationship of trust and confidence can be shown

. . . .

. . . . [A]n investor may be disserved when the broker causes the investor to take on additional risk absent a clear decision by the investor to do so, or at the very least, the informed consent of the investor. In other words, the broker should be liable when the broker *increases* the risk level of an investor's portfolio without at least the consent of the investor.

exposure, however, should continue to loom for those producers who take advantage of the asymmetry of knowledge between them and their customer, as well as in those instances in which an overbearing producer implicitly or explicitly induces (i.e., over-sells) the product based on his or her overt actions, course of conduct, or prior history with the customer.

CONCLUSION

Unfortunately, given the tenor of the debate thus far, it is highly improbable that the financial services industry will embrace a universal standard that harmonizes existing suitability standards. More likely, the insurance industry and the NAIC will continue to debate a model regulation that ignores securities law suitability standards for reasons such as: (a) the fundamental differences that exist between variable and traditional products as to perceptions about risk; (b) the infungibility of "needs" to be considered; (c) the existence of other market conduct protections; and (d) the fact that using a "recommendation" as the trigger for applying standards is too vague.²³² Ironically, securities and banking regulators could ultimately force a standard upon the insurance industry through the broad powers vested under the Gramm-Leach-Bliley Act.²³³ In the end, the insurance industry's failure to reach consensus may lead to

Id. (footnotes omitted).

232. See, e.g., Steven Brostoff, *NAIC and Legislators Vow: No NARAB, in NAT'L UNDERWRITER LIFE & HEALTH 1* (Apr. 17, 2000); Letter from Ronald J. Panneton, Assoc. Gen. Counsel, Nat'l Ass'n of Ins. and Financial Advisors, to Carolyn J. Johnson (Feb. 6, 2001) (on file with author). It has also been argued that state insurance department approval of certain policy forms mitigates the need for a suitability requirement presumably on the assumption that the insurance commissioner would not approve anti-consumer products. See, e.g., N.Y. INS. DEPT., *supra* note 40, at 7; Letter from Donald J. Walters to Carolyn J. Johnson, *supra* note 41, at 2.

233. See Gramm-Leach-Bliley Act, Pub. L. 106-102, 113 Stat. 1338 (1999). The Gramm-Leach-Bliley Act also evidences disparate deference to federal or state securities on one hand, and state insurance regulators on the other. See generally *id.* § 104(f)(1) (preserving the absolute jurisdiction of securities commissions to prevent fraud and oversee licensure or registration of brokers, dealers, and investment advisors); *id.* § 104(f)(2) (preserving the jurisdiction of state blue sky, corporate, and anti-trust regulators provided such laws or actions were not "inconsistent with the purposes of this Act"); *id.* § 305(g)(1)(B) (providing that state insurance regulatory authority is subject to federal banking agency consumer protection regulations and preemption provisions). Cf. *id.* § 323 (stating that one of the purposes of NARAB, if implemented, is to "preserv[e] the right of States to license, supervise, and discipline insurance producers and to prescribe and enforce laws and regulations with regard to insurance-related consumer protection and unfair trade practices."). But see *id.* § 307(a) (instructing the Federal Reserve Board and state insurance regulators to share information in order to encourage efficiency and quality supervision).

forced submission of a regulatory scheme that could favor securities brokers and bankers over insurance agents.²³⁴

Securities suitability standards and their litigious history provide many insights. Beyond their applicability to hybrid products, these standards affirm the existence of an informed consent standard where, in the proper circumstances, reasonably capable customers can assume responsibility for the outcomes of their investment decisions.²³⁵ Managing client expectations should not absolve producers, as experts, from their obligation to educate their customers about pertinent features of all recommended and otherwise available products, as well as the existence of possible conflicts of interest. However, contrary to present practice, a process and structure orientation to suitability would help establish a relatively ascertainable point at the conclusion of the solicitation process. At that time, absent discretionary authority, the producer (as well as his or her supervisors and product manufacturers) could reasonably conclude that he or she has conducted an appropriate and thorough inquiry as to the customer's investment objectives, financial situation, knowledge, and financial experience. The producer therefore has a reasonable basis to believe that the customer (a) has taken reasonable measures to evaluate the risks associated with the recommended product (in isolation and in terms of his or her overall holdings and other products), whether individually or with the assistance of other qualified advisors; and (b) has the financial capability to bear the potential consequences flowing from such purchase.

The present and future financial services industry has, and will continue to have, a dizzying array of distribution channels for advisory services and products. Separate standards for each type of product, producer, or site of sale are simply unworkable. Given the already somewhat tarnished public image of the insurance salesperson, it is easy to surmise why the insurance industry had better get

234. *Id.* § 321(b)(4); *see also id.* § 321(b)(1) (providing uniform licensing regarding qualification and training of producers "in ascertaining the appropriateness of a particular insurance product for a prospective purchaser"). Uniform licensing requirements that include suitability criteria may be averted if a majority of states establish either "uniform" or "reciprocal" producer licensing provisions by November 12, 2002. § 321(a). According to the NAIC, 46 states have passed legislation or adopted regulations attempting to satisfy this requirement. If these laws and regulations have truly established "uniform criteria" that ensures "that an insurance product . . . sold to a customer is suitable and appropriate for the customer based on financial information disclosed by the customer," § 321(b)(4), then—in theory—a multi-state suitability standard now exists.

235. *See* Gibson, *supra* note 22, at 571–81 (stating that institutional investors should assume investment risk associated with derivatives).

its house in order *fast*. Missing this historic opportunity may be the harbinger of a new era of financial service provider "Darwinism." In such a new world where old style insurance producer "relationship-ists" become extinct in favor of new style "transactional-ist" producers, there remains the final question: Who then, if anyone, will be his or her customer's keeper?