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June 2018

Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

NEW RULES

SEC Adopts New Rule Providing Optional Internet Availability of Fund Shareholder Reports and Requests Comment on Improving Fund Disclosures and Intermediary Processing Fees

Summary

On June 4, 2018, the SEC adopted new Rule 30e-3 under the Investment Company Act of 1940 (1940 Act) which creates an optional "notice and access" method for delivering shareholder reports. The new Rule allows certain registered investment companies—including mutual funds, exchange-traded funds, closed-end funds and certain registered unit investment trusts—to satisfy requirements to transmit shareholder reports by making them publicly accessible on a website, free of charge, and sending investors a paper notice of each report's availability, with instructions for requesting a paper or email copy. The SEC is adopting an extended transition period for Rule 30e-3 with staged effective dates; the earliest that a fund may rely on the Rule is January 1, 2021. The new Rule is intended to modernize the manner in which funds deliver periodic information to investors and follows other recently adopted SEC rules, forms and amendments to modernize the reporting and disclosure of information by funds.

New Rule 30e-3

Rule 30e-3 creates an optional "notice and access" method for delivering shareholder reports. In order to rely on the Rule, funds will be required to make their reports and other required materials publicly accessible, free of charge, at a website address specified in a short form paper notice to shareholders (a Notice), and meet certain other conditions, including protections for investors who continue to prefer paper reports or lack Internet access. To this end, Rule 30e-3 provides that investors may elect to receive paper reports on a per-report basis or through a one-

time request to receive all future reports in paper.

Other elements of Rule 30e-3 are as follows:

- **Required Information**

  The Notice must: (1) be in plain English; (2) contain a prominent legend in bold-face type stating that an important report to shareholders is available online and in paper by request; (3) state that the report contains important information about the fund, including its portfolio holdings and financial statements; (4) state that the report is available on the Internet or, upon request, by mail, and encourage shareholders to access and review the report; (5) include the website address where the shareholder report and other required portfolio information is posted (i.e., the "landing page" to those materials); and (6) include a toll-free telephone number to contact the fund or the shareholder's financial intermediary and (A) provide instructions describing how a shareholder may request, at no charge, a paper or email copy of the shareholder report or other materials required to be made accessible online and an indication that the shareholder will not receive a paper or email copy of the report unless requested, (B) explain that the shareholder can at any time in the future elect to receive paper reports and provide instructions describing how a shareholder may do so, and (C) if applicable, provide instructions describing how a shareholder can elect to receive shareholder reports or other documents and communications by electronic delivery.

- **Optional Content**

  The Notice may include: (1) information identifying the fund, its sponsor (including any investment adviser or sub-adviser to the fund), a variable annuity or variable life insurance contract or insurance company issuer thereof or a financial intermediary through which shares of the fund are held; (2) a brief listing of other types of information contained in the shareholder report, such as fund performance, portfolio manager commentary and expense information; (3) a QR code or other methods to access the website; and (4) any information needed to identify the shareholder—such as control numbers or account numbers—"so that shareholders may express their shareholder report transmission preference with ease."[1]

  In addition to the optional content noted above, the Rule's adopting release states that the SEC is "permitting additional flexibility regarding the content of the Notice," so long as it is limited to content from the shareholder report for which a Notice is being given. The adopting release identifies the following as information contained in shareholder reports that "may be communicative and appropriate—albeit not required" to be included in the Notice: graphical representations of fund holdings; a list of the fund's top holdings; performance information; a brief statement of the fund's investment objectives and strategies; the expense ratio or an expense example; and the name and title of the fund's portfolio manager(s). Pictures, logos or other designs may also be included "so

[1] The adopting release for Rule 30e-3 cautions that if a fund were to choose to include information in the Notice such as control numbers, account numbers, etc., to identify the shareholder, "the fund should take appropriate measures to protect this information just as funds do today regarding other mailings, like account statements, that may contain sensitive information."

long as the design is not misleading and the information is clear."

- **Three Business Day Delivery Requirement**
  Funds must send, at no cost to the investor and by U.S. first-class mail or other "reasonably prompt means," paper copies of the most recent annual and semi-annual reports of the fund and portfolio holdings of the fund as of its most recent first and third fiscal quarters to any person requesting copies of any such documents within three business days after receiving a request.

- **Notice May Accompany Account Statements**
  The Notice may be sent to an investor along with other materials, including a shareholder's account statement.

- **Required Mailing Period for Notice**
  The Notice must be sent to investors within 70 days after the close of the period covered by the related report.

- **Permitted Use of Consolidated Notices**
  A single, consolidated Notice may be used to alert shareholders to the online availability of shareholder reports for multiple funds. The Notice must incorporate all elements required by Rule 30e-3 with respect to each report covered by the Notice.

- **Availability of Quarterly Holdings**
  The Fund's quarterly holdings for the last fiscal year must also be publicly accessible on the website.

Elements Dropped from the Proposal

After considering industry comments, the SEC determined, among other things, not to require funds to mail a reply card with the Notice for investors to indicate their delivery preferences. The SEC also determined to eliminate from the final rule the proposed requirement that the Notice include the website address (URL) for each individual shareholder report.

Extended Transition Period

Rule 30e-3 is being implemented with "an extended transition period with staged effective dates" in order "[t]o inform investors in advance of the change of transmission method, and to accommodate systems and operations changes by funds, intermediaries and service providers necessary to implement the new optional transmission regime." In general, before relying on the Rule, funds will be required to provide two years of notice to shareholders through disclosures which alert them to the change in transmission method and allow them to express their delivery preference. (See "Related Amendments" below.)

The earliest that a fund may rely on the Rule to satisfy shareholder report transmittal requirements is January 1, 2021; funds wishing to do so must begin notifying shareholders at the start of 2019.

Funds newly offered during the period from January 1, 2019 through December 31, 2020 may rely on Rule 30e-3

starting on January 1, 2021 if they provide notice to shareholders starting with their first public offering. New funds offered on or after January 1, 2021 could rely on the Rule immediately without providing advance notice. All other funds may not rely on the Rule until they have completed a full two-year notice period or until January 1, 2022, whichever comes first.

Related Amendments

The SEC also adopted amendments to Rule 498 under the Securities Act of 1933 (1933 Act) and certain fund registration forms to require that funds intending to rely on Rule 30e-3 prior to January 1, 2022 provide prominent disclosures on the cover page or at the beginning of their summary prospectuses, and on the cover pages of their statutory prospectuses, and annual and semi-annual reports, informing investors of the upcoming change in delivery format options. These amendments to Rule 498 and Forms N-1A, N-2, N-3, N-4 and N-6 will be effective January 1, 2019 for a temporary period of three years (i.e., between January 1, 2019 and December 31, 2021).

Other amendments to Rule 498 will: (1) require funds relying on Rule 30e-3 to include as part of the legend on the cover page or beginning of the fund's summary prospectus the website address required to be included in the Notice; and (2) include the Notice among the materials that are permitted to have equal or greater prominence when accompanying a summary prospectus. Similarly, the SEC amended Rule 14a-16 under the Securities Exchange Act of 1934 to include a Notice among the materials that are permitted to accompany a Notice of Internet Availability of Proxy Materials. Additionally, Rule 498 is amended to permit the inclusion of information about electronic delivery of prospectuses and other fund documents and communications.

Request for Comment on Fund Retail Investor Experience and Disclosure

The SEC is also seeking public comment on other ways to modernize and enhance fund information. Pursuant to a separate release, the SEC is soliciting input from individual investors and others regarding the delivery, design and content of fund disclosures, including shareholder reports, prospectuses, proxy statements and fund advertisements.

Request for Comment on Processing Fees Intermediaries Charge for Forwarding Fund Materials

Additionally, the SEC is seeking public comment and additional data on the current framework for processing fees that broker-dealers and other intermediaries charge funds for delivering fund shareholder reports and other materials to investors. This request for comment responds to concerns about the rules of the New York Stock Exchange and other self-regulatory organizations (SROs) under which intermediaries are permitted to seek reimbursement for forwarding shareholder reports and other fund materials to investors that are beneficial owners of fund shares held in "street name" through the intermediaries. The SEC's request for comment states that "[w]ith the adoption of rule 30e-3, we believe it is appropriate to consider more broadly the overall framework for the fees that broker-dealers and other intermediaries charge funds, as reimbursement for distributing Fund Materials to investors." Among other things, the SEC requested comment on the clarity of SRO rules governing processing fees

and related out-of-pocket expenses and on the transparency and reasonableness of these fees.

Comments on either of the SEC's two requests for comment described above must be submitted by October 31, 2018.

The adopting release for new Rule 30e-3 under the 1940 Act and amendments to Rule 498 under the 1933 Act and fund registration forms is available at: https://www.sec.gov/rules/final/2018/33-10506.pdf

The request for comment on fund retail investor experience and disclosure is available at: https://www.sec.gov/rules/other/2018/33-10503.pdf

The request for comment on processing fees associated with delivery of fund materials is available at: https://www.sec.gov/rules/other/2018/33-10505.pdf

SEC STAFF GUIDANCE AND ALERTS

SEC Staff Issues No-Action Letter Permitting Temporary Hold on Disbursement of Redemption Proceeds from Direct-at-Fund Accounts to Protect against Financial Exploitation of Seniors and Other Vulnerable Investors

On June 1, 2018, the SEC's Division of Investment Management (Staff) issued a no-action letter to the Investment Company Institute (ICI) stating that the Staff would not recommend enforcement action against a mutual fund or its SEC-registered transfer agent (TA) under Section 22(e) of the Investment Company Act of 1940 (1940 Act) if the TA, acting on behalf of the mutual fund, "temporarily delays for more than seven days the disbursement of redemption proceeds from the mutual fund account of a Specified Adult held directly with the [TA] based on the [TA's] reasonable belief that financial exploitation of the Specified Adult has occurred, is occurring, has been attempted, or will be attempted." For purposes of this relief, a "Specified Adult" is "(A) a natural person age 65 and older; or (B) a natural person age 18 and older who the transfer agent reasonably believes has a mental or physical impairment that renders the individual unable to protect his or her own interests," and "financial exploitation" means "(A) the wrongful or unauthorized taking, withholding, appropriation, or use of a Specified Adult's funds or securities; or (B) any act or omission by a person, including through the use of a power of attorney, guardianship, or any other authority regarding a Specified Adult, to (i) obtain control, through deception, intimidation or undue influence, over the Specified Adult's money, assets or property, or (ii) convert the Specified Adult's money, assets or property." With the no-action letter, the Staff seeks to enable TAs to act to protect shareholder accounts held directly with the mutual fund and serviced by the TA—i.e., "direct-at-fund" accounts—to the same extent that broker-dealers may do so under FINRA Rule 2165, which permits a FINRA member to place a temporary hold on suspicious disbursements where there is concern about potential financial exploitation of seniors and other vulnerable investors.

Section 22(e) of the 1940 Act prohibits a fund from suspending the right of redemption or postponing the date of payment upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security to the fund or its designated agent. Under FINRA Rule 2165—which was approved by the SEC in February 2017—when a FINRA member has a reasonable belief that financial exploitation of a Specified Adult has occurred, is occurring, has been attempted or will be attempted, the member firm may, but is not required to, place a temporary hold on the disbursement of funds or securities from the Specified Adult's account, subject to certain conditions. In contrast, as the ICI explained in its letter to the Staff requesting no-action assurance, "when a fund's [TA] suspects financial exploitation in a direct-at-fund account, it cannot lawfully delay the disbursement of redemption proceeds while it investigates the situation . . . because the [TA] is acting as an agent of the fund … and it is the [TA] that ensures a mutual fund's compliance with Section 22(e)'s seven-day redemption period." In sum, as the ICI noted, "[t]he requirements of Section 22(e) may put certain mutual fund shareholders who own their shares direct-at-fund at a greater risk of harm from financial abuse than shareholders protected by FINRA's rule."

The Staff provided the no-action assurance sought by the ICI for the limited circumstances described in the ICI's letter and subject to certain conditions that correspond generally to the conditions imposed on broker-dealers under FINRA Rule 2165. The conditions applicable to TAs generally require, among other things, prompt notification of the temporary hold to authorized parties, immediate initiation of an internal review of the facts and circumstances, maintenance of the delayed redemption proceeds in the TA's "Demand Deposit Account" and compliance with certain record retention requirements. In addition, as part of the fund's compliance policies and procedures required pursuant to Rule 38a-1 under the 1940 Act, the fund must establish escalation and periodic reporting protocols requiring the TA to provide information about circumstances in which the TA relied on the Staff's no-action position.

The no-action letter is available at: https://www.sec.gov/divisions/investment/noaction/2018/investment-company-institute-060118-22e.htm

The ICI's request for no-action relief is available at: https://www.sec.gov/divisions/investment/noaction/2018/investment-company-institute-060118-22e-incoming.pdf

PROPOSED RULES

SEC Proposes FAIR Act Rules to Increase the Availability of Research Reports on Covered Investment Funds

Summary

On May 23, 2018, the SEC issued proposed rules and amendments designed to promote research on "covered investment funds," which include mutual funds, exchange-traded funds, registered closed-end funds, business development companies and certain exchange-listed commodity- or currency-based trusts or funds. The proposal would establish a safe harbor for an unaffiliated broker-dealer participating in a securities offering of a covered

investment fund to publish or distribute a research report under certain conditions. If the conditions are satisfied, the publication or distribution of the research report would not constitute an offer for sale of the covered investment fund's securities for purposes of the Securities Act of 1933 (1933 Act), even if the broker-dealer is participating or may participate in a registered offering of the covered investment fund's securities. The proposal was issued in accordance with the Fair Access to Investment Research Act of 2017 (FAIR Act), which was signed into law on October 6, 2017 and directed the SEC to propose and adopt rule amendments to extend the current safe harbor of Rule 139 under the 1933 Act—applicable to research reports about other issuers or their securities—to include "covered investment fund research reports."

Specifically, the SEC proposed the following:

1. New Rule 139b under the 1933 Act, which would establish a safe harbor for an unaffiliated broker-dealer participating in a securities offering of a covered investment fund to publish or distribute a covered investment fund research report;
2. New Rule 24b-4 under the Investment Company Act of 1940 (1940 Act), which would generally exclude a covered investment fund research report from the filing requirements of Section 24(b) of the 1940 Act; and
3. A conforming amendment to Rule 101 of Regulation M, which would permit distribution participants, such as brokers or dealers, to provide information about covered securities if certain conditions are satisfied.

Scope of Proposed Rule 139b

A "covered investment fund" includes (1) registered investment companies (or series or classes thereof), (2) business development companies and (3) others issuing securities in a registered offering if: (a) the securities are listed on a national securities exchange; (b) the issuer's assets consist primarily of commodities, currencies or certain derivative instruments; and (c) the issuer's registration statement reflects that its securities are purchased or redeemed for a ratable share of its assets. A "research report" is a written communication containing information, opinions or recommendations with respect to securities of an issuer or an analysis of a security of an issuer, regardless of whether the communication provides information reasonably sufficient on which to base an investment decision. A "covered investment fund research report," in turn, means a research report published or distributed by a broker or dealer about (1) a covered investment fund or (2) any securities issued by the fund. The term excludes a research report that is published or distributed by (1) the covered investment fund itself or any affiliate of the covered investment fund, or (2) any broker or dealer that is an investment adviser (or an affiliated person of an investment adviser) for the covered investment fund. Of the two foregoing categories of excluded research reports, the former is intended to prevent use of the safe harbor to avoid applicability of the 1933 Act's prospectus requirements, among other things, and the latter addresses the concern that a broker-dealer that is a fund's adviser, or an affiliated person thereof, may have financial incentives—such as promotion of the covered fund to increase sales—that could give rise to a conflict of interest.

Two Types of Covered Investment Fund Research Reports and Other Conditions

For a broker-dealer to rely on proposed Rule 139b, the research report must cover either a specific issuer ("issuer-specific research report") or a substantial number of issuers in an industry or sub-industry ("industry research report"). Other conditions for reliance on the proposed safe harbor are intended to track current Rule 139's conditions, to the extent practicable. For instance, as to both types of research reports, a broker-dealer is required to publish or distribute research reports in the regular course of its business, which tracks an existing requirement under Rule 139.

Issuer-Specific Research Reports

Issuer-specific research reports must satisfy certain reporting history, reporting timeliness and minimum public market value requirements that are consistent generally with the conditions for reliance on current Rule 139. For instance, for a covered investment fund that is a registered investment company, the fund would need to have (1) been subject to the 1940 Act's reporting requirements for a period of at least 12 calendar months prior to reliance on the proposed rule, and (2) timely filed all required reports during the immediately preceding 12 months. In addition, the covered investment fund that is the subject of the report must have a minimum aggregate market value of $75 million.

Industry Research Reports

Under the proposed safe harbor, each covered investment fund included in an industry research report must be subject to the reporting requirements of Section 30 of the 1940 Act (or Securities Exchange Act of 1934 reporting requirements for funds that are not registered under the 1940 Act). As with issuer-specific reports, this proposed reporting requirement is intended to "assure that there is publicly available information about the relevant issuers and that investors are able to use such information in making their investment decisions." Industry research reports are also subject to certain content and presentation requirements.

Proposed Rule 24b-4

Proposed Rule 24b-4 under the 1940 Act would exclude a covered investment fund research report from the filing requirements of Section 24(b) of the 1940 Act, except to the extent that the research report is not otherwise subject to self-regulatory organization—e.g., FINRA—content standards applicable to research reports. A covered investment fund research report would continue to be subject to FINRA recordkeeping requirements applicable to communications with the public, even if the broker-dealer would not be required to file the research report with FINRA or the SEC.

Proposed Amendment to Rule 101 of Regulation M

The proposed conforming amendment to Rule 101 of Regulation M would permit distribution participants, such as broker-dealers, to publish or disseminate any information, opinion or recommendation relating to a covered security so long as the conditions of Proposed Rule 139b are satisfied.[2]

Request for Comment

The SEC has requested comments on all aspects of the proposed rules, and specifically seeks comments on the

[2] Alternatively, if the conditions of Rule 138 or Rule 139 under the 1933 Act are satisfied, permission would be similarly granted.

proposed definitions of "covered investment fund research report," "research report" and "covered investment fund." Additionally, the SEC has requested comments on the following: (1) the proposed reporting history and timeliness requirements of an issuer-specific research report; (2) the proposed minimum market value requirement of an issuer-specific research report; (3) the regular-course-of-business requirement of both issuer-specific and industry research reports; (4) the reporting requirement of industry research reports; (5) the proposed content requirements for industry reports; and (vi) the proposed presentation requirement for industry research reports.

The public comment period on the proposed amendments will be open until July 9, 2018.

The SEC's proposing release for new Rules 139b and 24b-4 and the proposed changes to Rule 101 of Regulation M is available at: https://www.sec.gov/rules/proposed/2018/33-10498.pdf

Legislative Developments

Economic Growth, Regulatory Relief and Consumer Protection Act's Impact on Investment Management Industry

Summary

On May 24, 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act (Growth Act) was signed into law. Although much of the Growth Act focuses on rolling back certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), it also contains four provisions that will affect both registered and unregistered funds:

- **Section 3(c)(1)**: The Growth Act amends Section 3(c)(1) of the Investment Company Act of 1940 (1940 Act) to include a new exemption from the definition of investment company for a "qualifying venture capital fund" with up to $10 million in capital and fewer than 250 investors;
- **Closed-End Funds**: The Growth Act directs the SEC to propose and implement rules allowing certain registered closed-end funds to use securities offering and proxy rules otherwise available to non-investment companies that report under the Securities Exchange Act of 1934 (Exchange Act), "subject to conditions the [SEC] determines appropriate";
- **U.S. Possession Funds**: The Growth Act removes the exemption from registration under the 1940 Act for investment companies organized under the laws of Puerto Rico, the U.S. Virgin Islands or any other U.S. commonwealth, possession or territory; and

- **Volcker Rule Naming Restriction**: The Growth Act removes the Volcker Rule restriction prohibiting hedge funds and private equity funds advised by a "banking entity" from having the same name or a variation of the same name as the banking entity.

Expansion of Section 3(c)(1) Exemption

Section 3(c)(1) of the 1940 Act generally exempts from registration private funds that are beneficially owned by no more than 100 investors. The Growth Act expands this exemption to apply to "qualifying venture capital funds" beneficially owned by no more than 250 persons. A qualifying venture capital fund is a venture capital fund, as is defined in the Investment Advisers Act of 1940,[3] with no more than $10 million in aggregate commitments. The $10 million limit will be indexed for inflation by the SEC once every five years.

Offering and Proxy Rules Applicable to Closed-End Funds

The Growth Act mandates SEC rulemaking efforts intended to bring about "parity for closed-end companies regarding offering and proxy rules." Specifically, the Growth Act requires the SEC to propose by May 24, 2019, and finalize by May 24, 2020, rules to permit closed-end funds that either (1) have equity securities listed on a national securities exchange or (2) are interval funds pursuant to Rule 23c-3 of the 1940 Act to use securities offering and proxy rules available to non-investment companies that are required to file reports under Section 13 or Section 15(d) of the Exchange Act.

The expansion of such securities offering and proxy rules to closed-end funds will be "subject to conditions the [SEC] determines appropriate." During the rulemaking process, the SEC is directed to consider the availability of information to investors, including what disclosures are appropriate for designation of a closed-end fund as a "well-known seasoned issuer." In the event the SEC fails to finalize such rules within the prescribed time frame, exchange-listed and interval closed-end funds will be automatically deemed "eligible issuers" under the SEC's 2005 Securities Offering Reform release.

Registration of "Possession Funds"

Section 6(a) of the 1940 Act formerly exempted from registration investment companies organized or otherwise created under the laws of, and having their principal place of business in, Puerto Rico, the U.S. Virgin Islands or any U.S. possession. The Growth Act removes this exemption, requiring an investment company organized under the laws of any U.S. commonwealth, possession or territory to register as an investment company by May 24, 2021—three years from the enactment of the Growth Act. In its discretion, the SEC may extend this deadline for an additional period of up to three years.

[3] The Investment Advisers Act of 1940 defines a "venture capital fund" as any fund that (i) represents to investors that it pursues a venture capital strategy, (ii) holds no less than 80% of its capital in private operating companies, (iii) limits leverage to 15% of the fund's capital, (iv) limits redemption rights and (v) would be an investment company but for the exceptions provided under Sections 3(c)(1) or 3(c)(7) of the 1940 Act.

Volcker Rule Private Fund Naming Restrictions

The Bank Holding Company Act of 1956, as amended by Dodd-Frank, generally prohibits hedge funds and private equity funds from having the same name or a variation of the same name as a "banking entity" that is an investment adviser. The Growth Act amends this restriction to allow such naming conventions, provided that: (1) the investment adviser is not an insured depository institution or its control company, or a company that is treated as a bank holding company under the International Banking Act; (2) the investment adviser does not share a name with an insured depository institution or a bank holding company; and (3) such name does not contain the word "bank."

The full text of the Growth Act is available at: https://www.congress.gov/115/bills/s2155/BILLS-115s2155enr.xml

Registered Insurance Product Developments

NY Department of Financial Services Issues Updated Proposal Adopting a "Best Interest" Standard for Life Insurance and Annuity Product Transactions, Including for In-Force Transactions

The New York State Department of Financial Services (DFS) has amended its proposal to adopt a "best interest" standard for those licensed to sell life insurance policies and annuity contracts. Among other things, the proposed rule, which would amend New York's current suitability regulation, Insurance Regulation 187 (11 NYCRR 224), would require insurance companies to establish standards and procedures for recommendations to consumers for insurance products "delivered or issued for delivery" in New York to ensure that any sales transaction is in the best interest of the consumer and "appropriately addresses the [consumer's] insurance needs and financial objectives" at the time of the transaction.

As currently presented, the proposal would:

- expand the purpose of the regulation to apply to life insurance transactions—in addition to transactions in annuity contracts;
- clarify that the duties of insurers and "insurance producers" (insurance agents or brokers) apply to life insurance recommendations, in addition to applying to annuity recommendations;
- make any requirement applicable to a producer under the regulation applicable to every producer in the transaction who participated in the making of the recommendation and received compensation as a result of the sales transaction, regardless of the level of contact made with the consumer;
- broaden the applicability of the regulation so that, in addition to sales transactions, it would cover any modification or election of a contractual provision with respect to an in-force policy that does not generate

new sales compensation;

- prohibit stating or implying that a recommendation to enter into a sales transaction or an in-force transaction is "financial planning, comprehensive financial advice, investment management or related services" in the absence of a specific certification or professional designation, with proper licensing, as applicable; and
- require an insurer to establish, maintain and audit a system of supervision that is reasonably designed to achieve compliance with the amended regulation; establish and maintain procedures to prevent financial exploitation and abuse; provide any policy information reasonably requested by a consumer regarding the consumer's in-force policy; provide comparison information showing differences between fee-based and commission-based versions of a product; and provide relevant policy information.

Standard of Conduct

The existing standard of conduct in New York requires that there be "reasonable grounds for believing that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer as to the consumer's investments and other insurance policies or contracts and as to the consumer's financial situation and needs, including the consumer's suitability information."

The proposed amendment would provide for a best interest standard of care for all sales of life insurance and annuity products, applicable to recommendations made both prior to sale of an insurance product and, notably, during the servicing of the product.

For sales transactions, the best interest standard would require that the recommendation to the consumer be "based on an evaluation of the relevant suitability information and reflects the care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use under the circumstances." Additionally, the new standard would require that (1) the sales transaction be suitable, and (2) there be a reasonable basis for believing that the consumer has been reasonably informed of various features of the product and "potential consequences of the sales transaction, both favorable and unfavorable, such as the potential surrender period and surrender charge, any secondary guarantee period, equity-index features, availability of cash value, potential tax implications . . . policy exclusions or restrictions . . . any differences in features among fee-based and commission-based versions of the policy and the manner in which the producer is compensated for the sale and servicing of the policy… "

The proposed amendment would add a new section to the regulation to incorporate a best interest standard on in-force transactions. As a result, the insurance agent or broker (i.e., a producer), or insurer where no producer is invovled, would be required, among other things, to have a reasonable basis for believing that the consumer has been reasonably informed of the relevant features of the policy and potential consequences of the in-force transaction, both favorable and unfavorable. In addition, an insurance producer would be prohibited from making a recommendation to a consumer to enter into an in-force transaction about which the producer has inadequate knowledge.

Procedures to Prevent Financial Exploitation and Abuse

The amended regulation would require insurers to establish and maintain procedures designed to prevent "financial exploitation and abuse." The proposal defines financial exploitation and abuse as the improper use of an adult's funds, property or resources by another individual and includes fraud, false pretenses, embezzlement, conspiracy, forgery, falsifying records, coerced property transfers or the denial of access to assets.

The amended regulation was published in the New York State Register on May 16, 2018, and the public comment period closed on June 15, 2018.

The text of the proposed regulation is available at: https://www.dfs.ny.gov/insurance/rproindx.htm

A press release issued by DFS regarding the proposal is available at: https://www.dfs.ny.gov/about/press/pr1804271.htm

FINRA Sanctions Member for Variable Annuities Sales Practices

On May 8, 2018, FINRA settled an enforcement matter against Fifth Third Securities, Inc. (Fifth Third) relating to the firm's variable annuities (VA) sales practices. In the letter of acceptance, waiver and consent, FINRA alleged that from 2013 to 2015, "Fifth Third made negligent misstatements and omissions of material fact to customers" regarding the costs and benefits of exchanging one VA with another, "failed to have a reasonable basis to recommend and approve" the sample of exchanges FINRA reviewed, and failed to adequately supervise VA exchanges.

Fifth Third previously settled an enforcement action with FINRA in 2009 regarding its VA sales practices. In that settlement, Fifth Third agreed to a censure and to the payment of a $1.75 million fine plus restitution. At that time, Fifth Third also agreed to retain an independent consultant to review its supervisory procedures relating to VA sales practices and to implement those procedure changes.

Relative to the more recent enforcement action, FINRA reviewed a sample of VA exchanges that Fifth Third approved between 2013 and 2015 and found that Fifth Third had misstated or omitted at least one material fact relating to the costs or benefits of the VA exchange in approximately 77% of the exchanges in the sample. The misstatements or omissions included: (1) overstating the total fees of the existing VA or misstating the fees associated with various optional riders; (2) failing to disclose that an existing VA had an accrued living benefit value, or understating the living benefit value, that the customer would forfeit upon an exchange; and (3) misstating that the new VA would have a living benefit rider in cases in which it did not have such a rider. Fifth Third ultimately approved 92% of VA exchange applications despite not having a reasonable basis to recommend and approve many of those transactions.

FINRA found that: (1) Fifth Third did not ensure that its registered representatives obtained and assessed accurate

information concerning the recommended VA exchanges; (2) Fifth Third's registered representatives and principals were not adequately trained to conduct a comparative analysis of the material features of VAs; and (3) Fifth Third misstated the costs and benefits of VA exchanges, causing the exchanges to appear to be more beneficial to customers than they actually were. Additionally, FINRA found that Fifth Third had failed to implement the independent consultant's changes to its supervisory procedures for VA sales, as required by the 2009 settlement.

Without admitting or denying the allegations, Fifth Third consented to the entry of FINRA's findings and agreed to a censure and to the payment of a fine of $4 million to FINRA plus restitution in an aggregate amount of approximately $2 million to customers. Fifth Third also agreed to implement improved policies and procedures relating to the supervision of VA sales.

The letter of acceptance, waiver and consent is available at:
http://www.finra.org/sites/default/files FifthThirdSecurities_AWC_102015.pdf

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