ACCEL LAW GROUP

WHITE PAPER

Overview of the Regulatory and Compliance Obligations of Insurance Producers, Agents and Brokers

INTRODUCTION

Up until the 1990s, most insurance producers, agents and brokers[1] transacted business on a local or regional basis, with only the larger agents and brokers transacting business in multiple states. The advent of the internet and changes to streamline the producer licensing process allowed many historically "Main Street" or regional businesses to dramatically expand the footprint of where they transact business.

The U.S. insurance industry is heavily regulated. Producers selling products in multiple states are often confounded by the complexity of the statutes, regulations and regulatory directives governing their actions in the marketplace.

With limited dedicated compliance resources, many independent producers find it challenging to effectively manage their compliance obligations across multiple jurisdictions. While the laws governing producers are less onerous than those governing insurance companies or securities brokers, insurance producers are often frustrated by the lack of consistent regulation between states and lack of clear guidance on certain regulatory topics. This article provides a high-level overview of the U.S. insurance regulatory system and the state insurance laws governing insurance producers, agents and brokers and is intended to provide the reader with a general understanding of the regulatory issues that commonly confront producers.[2]

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U.S. Insurance Regulatory System

State Based Regulatory System

U.S. insurance business is primarily regulated at the state level. Each state has an insurance department ("DOI"), statutes and regulations, and policies and procedures that govern the activities of producers. The U.S. Supreme Court held in United States v. South-Eastern Underwriters Association[3] that Congress had the power to regulate the insurance industry. In response, Congress enacted the McCarran-Ferguson Act, which, broadly speaking, left regulatory control over insurance to the states.

With each state developing its own set of laws governing the insurance industry, a patchwork system of regulation developed across the country. As a result, producers are subject to varying regulation in every jurisdiction in which they transact business. This can be quite onerous for businesses transacting business in numerous jurisdictions or nationwide.

National Association of Insurance Commissioners

Formed in 1871, the National Association of Insurance Commissioners ("NAIC") helps achieve some uniformity among the states in the regulation of insurance. The NAIC is a private organization that serves as a vehicle for cooperation among state regulators, by proposing model laws for consideration by state legislatures and pooling resources through central databases. While the NAIC is a voluntary organization and cannot force state legislatures to enact laws or DOIs to follow its directives, it is a strong influence on state regulation.

PRODUCER LICENSE REQUIREMENTS

Agents, Brokers and Producers

Insurance companies authorized to transact business in one or more U.S. jurisdictions bring their products to market through agents and brokers. The "agent" acts as the sales representative for the insurance company. The "broker" usually acts on behalf of the insured.

Over time, the distinction in the U.S. between agents and brokers has become blurred as intermediaries represent both insurers and insureds. Recognizing this, the insurance laws of most states have been amended to replace the separate license requirement for agents and brokers and to combine both licenses into a single "producer" license. In such states, a licensed producer can act as either an agent, on behalf of an insurer, or broker, on behalf of the insured.

Similar to the requirements in the state of formation, once an agency is "foreign qualified", that foreign state may require the agency to (a) file an annual report, (b) pay taxes, and (c) submit to the state's regulations for foreign entities. Because of these regulatory burdens, many insurance agencies simply avoid becoming foreign qualified unless the foreign state's Department of Insurance requires qualification or their activities in that state clearly indicate they are "transacting business in the state" and require qualification (e.g., the entity has an office or employees in the state). It is advisable to seek guidance from your legal counsel or accountants to determine if foreign qualification is required, as failure to qualify can subject the agency to enforcement actions, including significant fines and penalties.

Licensing Requirements

In the U.S., producer licensing requirements are found in the producer licensing laws of each state. Each of the 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands has adopted legislation substantially similar or related to the NAIC Producer Licensing Model Act (the "PLMA") (Model 218).

Regarding licensing requirements, Section 3 of the PLMA provides as follows:

> A person shall not sell, solicit or negotiate insurance in this state for any class or classes of insurance unless the person is licensed [as a producer] for that line of authority in accordance with this Act.

The term "person" is defined in the PLMA to include individuals and business entities. With few narrow exceptions, any individual or entity engaging in the sale, solicitation or negotiation of an insurance product is required to be licensed as a producer for that class or line of business.

Activities for Which a Producer License is Required

Section 2 of the PLMA defines the terms "sell", "solicit", and "negotiate" as follows:

> "Sell" means to exchange a contract of insurance by any means, for money or its equivalent, on behalf of an insurance company.
>
> "Solicit" means attempting to sell insurance or asking or urging a person to apply for a particular kind of insurance from a particular company.
>
> "Negotiate" means the act of conferring directly with or offering advice directly to a purchaser or prospective purchaser of a particular contract or insurance concerning any of the substantive benefits, terms or conditions of the contract, provided that the person engaged in that act either sells insurance or obtains insurance from insurers for purchasers.

The statutory definitions of the terms sell, solicit and negotiate in most states are broad and open to interpretation by state regulators in terms of the specific activities triggering producer license requirements. That said, an unlicensed person is generally prohibited from engaging in the following activities:

- Describing or explaining the benefits or terms of insurance coverage, including premiums;
- Offering an invitation to contract (e.g. an application) to prospective purchasers;
- Making general or specific recommendations as to insurance products;
- Accepting orders or applications for insurance products;

- Comparing insurance products, advising as to insurance matters, or interpreting policies or coverages; and
- Urging a person to apply for a particular kind of policy from a particular company.

These guidelines also apply to printed materials and internet web pages and portals.

Exceptions from Producer License Requirements

PLMA Section 4 and the laws of most states include certain exceptions from producer license requirements for officers, directors or employees of licensed producers or insurance companies, enrollers in connection with certain lines of business and persons involved in advertising and mass media. It should be noted, however, that none of these exceptions permits an unlicensed person to engage in the sale, solicitation or negotiation of insurance, so such exceptions are not as broad as they may appear.

PRODUCER LICENSING PROCESS

As previously stated, all individuals selling, soliciting or negotiating insurance and the companies they represent must be licensed in every jurisdiction in which they sell insurance.

Individual Pre-licensing Coursework and Examination

For an individual to obtain a producer license he or she must satisfy certain pre-licensing course work and pass an examination in his or her resident state. Once these requirements have been satisfied, the individual may apply for an individual resident producer license. An applicant for an individual producer license must provide certain personal information (name, address, date of birth, social security number, etc.) and answer background questions regarding prior work history and any bankruptcies or criminal history. Individuals with a criminal record, especially acts involving fraud or dishonesty, are generally prohibited from obtaining a license and DOIs have discretion to withhold a license from individuals based on untrustworthy character.

An insurance producer may receive qualification for a license in one or more of the following lines of authority: life, accident and health and sickness, property, casualty, variable life and variable annuity products, personal lines, credit and any other line of insurance permitted under specific state laws.[4] Certain lines of authority may require an additional exam or course requirements.

Entity Producer Licensing and Designated Responsible Producer

If a licensed individual is soliciting insurance on behalf of an entity (e.g., c-corp., s-corp., limited liability company or limited liability partnership), the entity must also obtain a producer license in most states. For an entity to obtain a resident

entity producer license it must have at least one designated responsible individual producer ("DRP")[5] who is licensed in the line of authority for which the entity wishes to become licensed. The DRP requirements vary from state-to-state, with some states requiring the DRP to be an officer of the company and others having requirements and restrictions on the number of DRPs associated with the entity license. Producer entities must also take care to replace the DRP when the appointed DRP leaves the company or risk losing the entity license.

The DRP will be liable for any insurance law violations by the entity. Further, an entity license can be withheld if any individual with control over the entity, whether a producer or owner, has committed certain criminal acts. A minority of states require a DRP for each branch office located in the state who is responsible for the producers that work at the office and report to the DRP. Like the application requirements for an individual producer license, owners, officers, directors, members and managers must provide certain personal information (name, address, date of birth, social security number, etc.) and answer background questions regarding prior work history and any bankruptcies or criminal history. An entity's application may be denied if an individual associated with the entity is determined to be of untrustworthy character.

Resident and Non-resident Licenses

Once the individual and entity are licensed as producers in their resident state, they may seek non-resident licenses in other states. Most states will grant reciprocity to the individual applicant based on completion of pre-licensing coursework and successfully passing the examination in his or her resident state.

National Insurance Producer Registry and Producer Database[6]

One area where the NAIC has created significant uniformity among the states is in the producer licensing process through the formation of the National Insurance Producer Registry Gateway ("NIPR") and the Producer Database ("PDB"). The NIPR is a communication network allowing producers to submit initial license and renewal information electronically to the DOIs. The NIPR has greatly streamlined the licensing and renewal process by reducing paperwork and shortening the regulatory review period. The PDB is an electronic database that acts as the central warehouse for information regarding licensed producers.

OTHER REGULATORY CONSIDERATIONS

In addition to the licensing issues discussed above, there are other licensing considerations that all producers should be aware of, including:

- **Agent affiliations:** Approximately half of all U.S. jurisdictions require licensed producer entities to provide notice to the DOI of all individual licensed producers affiliated with the entity, and to also provide notice of termination of any individual affiliated with the entity.

- **DBA, Fictitious and Trade Names:** Many states have requirements and restrictions governing the use of alternative names by licensed entity producers. In some states, the agency must be separately licensed under any name used by the agency.

- **Branch Office Locations:** Similarly, some states require each branch office located in a state to be separately licensed or registered and may require appointment of a DRP to manage each such location.

- **Continuing Education:** Individual licensed producers are subject to continuing education in their state of residence and must show evidence of satisfaction of such requirements to renew their license. It should be noted that failure of the DRP to satisfy continuing education requirements will likely also result in suspension of the entity producer license.

- **License Renewals:** Most licenses expire, requiring the producer to file a renewal application annually or biannually. This process enables the DOIs to confirm continuing education requirements and that the DOI has updated data on the licensee.

- **Updating Licensee Information:** If information filed in an application changes, the producer may be required to notify the DOI within a specified period or on renewal of the license. A producer should consult the laws of states in which they are licensed upon a change in the following:

    - Change in address of the licensee;
    - Change in phone or email;
    - Appointment and removal of a DRP;
    - Hiring or terminating a producer;
    - Change in ownership of a licensed entity; or
    - Changes in officers, directors, or managers.

- **Reporting of Administrative Actions:** Licensed producers are required to provide notice to the DOI in states in which they are licensed of administrative actions taken in other states. This requirement is satisfied by posting the action to the NIPR for viewing by state regulators.

- **Agent Appointments:** In most states, an insurance company is required to appoint all agents (not brokers) acting on behalf of the company. Although the duty to appoint is the responsibility of the insurance company, certain states require that the agent hold at least one insurance company appointment to maintain its license. If the producer has only one appointment, and it is terminated, then the license would become inactive for lack of an appointment.

- **Managing General Agent:** The terms "managing general agent" and MGA[7] are commonly used in the insurance industry in reference to a producer delegated a higher level of authority to act on behalf of an insurance company than a typical general agent. What many people do not realize is that in most states the term "managing general agent" is defined by statute as an agent that "underwrites an amount of gross direct written premium equal to or more than 5% of the policyholder surplus as reported in the last annual statement" and either (i) adjusts or pays claims in excess of $10,000 per claim, or (ii) negotiates reinsurance on behalf of the insurer.[8]

  Most producers do not control enough business of an insurance company to fall within the statutory definition. Those that do are required to become licensed as an MGA, either by obtaining a separate license or as an additional designation on its existing producer license, and state laws typically require the agreement between the producer and insurance company to include certain provisions subject to the review and approval of the DOI.

- **Foreign Qualifications:** Foreign qualification requirements can cause significant confusion as producers expand into new states. All states require foreign companies to obtain a certificate of authority from the state's Secretary of State if it "conducts business" or "is doing business" in the state. These terms are not defined, and there is no bright line test. Some states take the position that an entity producer must be foreign qualified if it is licensed in the state regardless of whether the producer conducts any activities directly within the state. Foreign companies transacting business in a state and not falling within an applicable exemption must register with the secretary of state and, in some states, the tax authority.

- **Surplus Lines:** To transact surplus lines business, a producer must be authorized to do so by obtaining a separate surplus lines license or an additional designation on the producer's license. Surplus lines brokers are also subject to other requirements, including, diligent search requirements, reporting requirements, and tax filing requirements. They are also required to register with the surplus lines office (AKA stamping office) in certain states.

- **Regulatory Sanctions:** Failure to comply with state laws, including the requirements and restrictions discussed above, will subject the licensee to regulatory sanctions, including fines and other monetary penalties, license suspension and revocation and, for some violations, criminal penalties for owners, officers and directors, or managers.

COMPENSATION AND COMMISSION SHARING

Commission Sharing

PLMA Section 13 prohibits insurance companies from paying (and an unlicensed person from receiving) a "commission, service fee, brokerage or other valuable consideration" to an unlicensed person for the sale, solicitation or negotiation of insurance. Conversely, the PLMA expressly permits an insurer or producer to pay or assign "commissions, service fees, brokerages or other valuable consideration" to persons who do not sell, solicit or negotiate insurance, unless the payment would violate state anti-rebate laws (discussed in further detail below).

Referral Fees

In light of the restriction on paying commissions to unlicensed persons for activities requiring a producer license, questions commonly arise regarding payments to persons who make referrals to licensed producers. It should be noted that a number of states limit such payments. For example, Delaware law provides that a producer may pay a referral fee to an unlicensed person if (i) such unlicensed person does not discuss specific policy terms or provide opinions or advice, (ii) the referral fee is a fixed nominal[9] amount, and (ii) the fee is not dependent on the sale or volume of insurance placed.[10]

Administrative Fees

Questions also commonly arise as to whether a producer may charge fees in addition to standard commissions. The laws of certain states provide a producer acting as a broker that receives compensation for placing an insurance policy may not accept an administrative fee from the insured or other third party unless prior to the client's purchase of the policy, the producer:

1. Obtains the clients acknowledgement that the producer will receive the administrative fee;
2. Discloses the amount of compensation from the insured the producer will receive, or the method of calculation, and if possible, a reasonable estimate of the amount; and
3. Can show the fees are for services beyond normal policy administration services for which the producer receives commissions.[11]

Appointed agents of an insurance company are generally prohibited from charging the insured any amount in addition to commissions.

UNFAIR TRADE PRACTICES

In addition to licensing requirements and compensation rules, producers are subject to regulation under state unfair trade practices laws, which in most states are based on the NAIC Unfair Trade Practices Model Act (Model 880). The unfair trade practices laws in most states prohibit producers form engaging in

certain conduct, including making misrepresentations in policy terms or benefits, providing false information or engaging in defamation, or engaging in unfair discrimination.

Some states also restrict producers from tying the sale of insurance to the purchase of another product or from offering free insurance, on the theory that the insurance is not actually free but is simply included in the cost of a good or service. Finally, some states restrict the amount of business a producer may place for itself, its employees and/or affiliates (commonly referred to as "controlled business" statutes).

Rebating and Value-Added Services

The unfair trade practices laws of most states prohibit a producer from offering anything of value not set forth in the policy as an inducement to insurance. State anti-rebating laws were originally enacted to prevent discrimination between similarly situated insureds and insurer insolvencies. Today, these statutes prohibit conduct that on its face would appear to benefit the consumer and is commonplace in many other industries.

The most obvious rebate is a cash return of part of the premium to the policyholder, or the acceptance of an amount less than the full premium payable, ordinarily through a reduction in the producer's commission. State insurance regulators have found that other less obvious benefits tied to the sale of insurance violate anti-rebating laws, including the following:

- providing goods or services at no cost or at a discount;
- renting office space at excessive rates from companies purchasing a substantial amount of insurance from a producer or insurer;
- joining the insurance transaction with a sale of stocks or bonds at a price lowered by the amount of the proposed rebate;
- retaining and compensating the policyholder or a representative of the policyholder for acting in a fictitious "advisor" role;
- selling shares to policyholders in proportion to the premium volume of business placed and declaring dividends; and
- giving the insured a favorable interest rate on a loan used to pay the premium.

The New York Department of Financial Services ("NY DFS") has been by far the most active DOI in terms of issuing guidance with respect to the scope and application of its anti-rebating statutes, and has issued numerous Office of General Counsel Letters on the topic. In 2009 the NY DFS issued Circular Letter 9, which clarified its position with respect to free "value-added" services offered by employee benefits brokers.[12]

RECORDKEEPING AND FIDUCIARY ACCOUNTS

Recordkeeping

State insurance laws place relatively few recordkeeping requirements or restrictions on producers. Instead, the recordkeeping practices of producers are typically dictated by agreements with insurance companies and laws of general application, not specific to the insurance industry, including privacy and data protection laws. The laws governing insurance company recordkeeping requirements are much more prescriptive, particularly with regard to document retention. Therefore, these requirements are typically reflected in the agreement between the insurer and the producer as part of the authority delegated by the insurance company to the agent.

In recent years, the NAIC and state regulators have become increasingly focused on cyber-security and data collection. In early 2017, the NY DFS issued the most comprehensive cyber-security regulation issued to date specifically targeted at insurance companies, producers and other entities with whom they share information.[13] Producers can be penalized for not having a written cyber-security plan and maintaining certain precautions, even if a breach never occurs. It is expected that other states will follow New York shortly and enact laws and issue regulations governing the way in which producers manage consumer information.

Fiduciary Accounts

In most U.S. jurisdictions, licensed producers are subject to regulation with regard to accounting and fiduciary accounts. These laws generally provide that premiums received by a producer shall be held in a fiduciary capacity for the insurer, that producers may not commingle funds, and that, in some jurisdictions, funds may only be withdrawn in accordance with regulations. In addition to producer fiduciary account laws, the agency agreement between a producer and an appointing insurance company typically also includes requirements for the producer regarding fiduciary account maintenance, account recordkeeping, reporting, and accounting requirements.

NOTES

1 As discussed in further detail below, the laws of most states now provide for a single "producer" license that permits the licensee to act as the "agent" of the insurance company or "broker" representing the insured. We use the term "producer" unless the context requires otherwise.

2 Note that the article provides an overview of state laws and regulations governing insurance producers, agents and brokers and we do not address: (i) laws governing insurance companies and insurance products; (ii) state and federal securities laws; (iii) the Employee Retirement Income Securities Act of 1974; (iv) state and federal tax and employment laws; and (v) laws of general application not specifically targeted at insurance producers, agents and brokers.

3 322 U.S. 533 (1944).

4 Producers selling variable life or variable annuities and other investment products are also subject to securities license requirements.

5 Other terms used by states include sub-licensee, compliance officer, agent in charge, responsible individual, or affiliated agent, rather than DRP.

6 In January of 2015, Congress enacted legislation establishing the National Association of Registered Agents and Brokers (NARAB), which is tasked with creating a federal producer licensing system permitting a producer licensed in his or her home state to obtain a single license for all states. If implemented, it will provide an option to maintaining licenses in multiple states. To date, no meaningful progress has been made to appointing a board of directors or advancing the objectives of NARAB.

7 Other terms used include program administrator, managing general underwriter or MGU.

8 See NAIC Managing General Agents Act (Model 225).

9 The threshold of what is considered nominal is generally within the discretion of the insurance commissioner, and is typically less than $50 in most states.

10 Del. Code Ann. tit. 18, § 1714.

11 See e.g., N.Y. Ins. Law § 2119(c).

12 For a full discussion of state anti-rebating laws and value-added services, see You Can't Get – or Give – Something for Nothing, FORC Journal, Summer 2009, available at http://www.forc.org/Public/Journals/2009/VOL_20_Summer_2009_Edition.aspx.

13 See N.Y. Comp. Codes R. & Regs. tit. 23, § 500.