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CONFLICT OF INTEREST OF INSURANCE BROKERS

RECENT DEVELOPMENTS IN US AND CHINA AND PROSPECTS FOR THE REGULATION IN THE EUROPEAN UNION

Abstract. - The Authors consider how three dissimilar jurisdictions, the United States, China and the European Union, review and regulate conflicts of interest of insurance brokers. The U.S. section briefly summarizes state-based insurance regulation, the public and private litigation surrounding contingent fee commissions, and proposals for regulatory change. The China section focuses on recent legislation mandating specific disclosures by brokers on compensation and the author suggests that disclosure alone is not a fully adequate remedy for the potential conflicts of interest. The EU section reviews Article 12 of Directive 2002/02/EC on insurance and general requirements of suitability, discusses whether the MiFID Directive for investment services offers useful solutions, and concludes with a similar concern that disclosure alone may not be an effective remedy to counter-balance the powerful economic incentives aligning insurance brokers with insurance undertakings. The three authors caution that disclosure alone may be ineffective in policing this area, particularly with personal lines or retail customers. Further, insurer-based compensation schemes

can create conflict of interest problems with independent insurance agents as well, an issue that none of the jurisdictions appear to address.

Key words: insurance broker, independent insurance agent, broker's commission, contingent broker's commission, conflict of interest of insurance broker and client / consumer, disclosure on commission

THE UNITED STATES

Insurance regulation in the United States contrasts strikingly to the European Union and China due to its fragmentary nature. Insurance is regulated by the individual states and consequently there are more than 55 insurance regulatory jurisdictions in the U.S. (the 50 states and several territories – e.g., the District of Columbia), with each regulatory agency generally having exclusive authority over the insurance industry in its state. Since 1944 the federal government has had the clear constitutional authority to regulate this sector, as it largely does in banking and securities, but it has specifically declined to do so.¹ The National Association of Insurance Commissioners (NAIC), a private organization composed of the insurance regulators in each state and territory, provides the potential, and often the reality, of serving as a force for unity and consistency in state insurance regulation and has passed numerous model laws that the states have adopted in whole or in part.² However, the NAIC has essentially no law-making or enforcement powers, and it is up to the states to adopt its recommendations. Further complicating this regulatory tangle is that the United States is a common-law jurisdiction and case law provides significant guidance in inter-

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¹ In *United States v. South-Eastern Underwriters Association*, 322 U.S. 533 (1944) the Supreme Court held that insurance was considered interstate commerce under the Commerce Clause of the U.S. Constitution (U.S. Const. art. I, § 8, cl.3) and therefore subject to federal regulation. State insurance regulators and the industry promptly organized and convinced Congress to maintain the paramount role of state insurance regulation with the 1945 passage of the McCarran-Ferguson Act, 15 U.S.C. § 1011, *et seq.* The McCarran-Ferguson Act is often mischaracterized as an obstacle to a federal role in insurance regulation. This is not true; rather this Act asserts that federal law will not be interpreted as preempting state laws regulating the "business of insurance," unless the federal law so directs. Congress can, and has, passed significant insurance legislation in specific areas, for example, the Terrorism Risk Insurance Act of 2002 (15 U.S.C. § 6701 note), and the National Flood Insurance Program (42 U.S.C. § 4011, *et seq.*)

² See <http://www.naic.org>

preting and understanding insurance regulation and the duties of brokers, agents, insurers and policyholders; case law in this area, and many others, often differ state by state.

Despite this abundance of regulatory authority, states define insurance brokers and agents with fair uniformity, employing the familiar distinctions found in the EU and China. Insurance agents are considered representatives of the insurer, with their authority typically determined by their agency contract. In contrast, an insurance broker solicits or negotiates insurance on behalf of an insured. These general terms also define each other; for example, in New York, the statutory definition of an insurance agent specifically excludes brokers.³ Depending upon the authority granted, a true insurance agent can bind the insurer to coverage, premium collection, and at times coverage interpretations inconsistent with what the insurer may have intended.⁴ However, this formal distinction between "agent" and "broker" breaks down in application, with insurers, agents, brokers, policyholders, lawyers and the courts often using these terms interchangeably.⁵ Indeed, an insurance producer's self-identification as an "agent" or "broker" may have little legal significance and courts will focus on the specifics of the relationship when determining whether the producer is an agent of the insurer or policyholder. Generally, in the U.S. actual insurance brokers represent medium to large commercial policyholders rather than individuals (e.g., Marsh, Aon Corporation).

There is a long tradition of independent insurance agents in the United States who have the authority to sell insurance on behalf of multiple insurers, in ad-

dition to agents contracted to (or employed by) a single insurer (e.g., State Farm). These independent agents are also typically considered agents of the insurer rather than the policyholders. Their focus on independence and consumer choice as a way of marketing themselves to clients creates the possibility of a conflict as they are still compensated by commissions from whichever insurer is selected to write the policies, and even today most states do not require agents to disclose to their clients the amount of compensation/commission received. This conflict between formal agency arrangements, compensation practices and consumer expectations (fostered by agents, brokers and their trade associations) is not unique to insurance and in the U.S. is also common in the mortgage and stock brokerage industries.⁶

Insurers have historically utilized a variety of incentives to encourage independent agents and brokers to place their business with their companies, ranging from additional commissions to elaborate trips and vacations for top producers. Accordingly, there is a separation, and inherent *potential* conflict between the legal duty brokers and agents owe to their clients and the nature and extent of their compensation, which is paid by and determined by the insurers. This potential is amplified through the use of contingent commissions - agreements between brokers or agents and insurers where the percentage commission increases based on the volume or quality of business the broker directs to a particular insurer. These compensation plans are powerful economic incentives to brokers and agents to place insurance with insurers that offer the best compensation arrangements, perhaps contrary to the best insurance value for their clients.

³ N.Y. Insurance Law § 2101(a).

⁴ There are abundant examples in American insurance case law where an insurance agent's promises as to particular coverages or protections provided in the policy have later obligated the insurer despite language in the insurance policies perhaps inconsistent with those promises, e.g. *C&J Fertilizer v. Allied Mutual Insurance*, 227 N.W.2d 169 (Iowa 1975).

⁵ For example, the largest and most powerful trade association for independent agents in the United States is the Independent Insurance Agents and Brokers of America. To the public this Association makes little attempt at distinguishing between an agent and broker and emphasizes the advantage of independence of both for customer choice. See www.iiaba.net.

⁶ This separation between an insurance producer's duty and its source of compensation is paralleled in liability insurance, where the insurer usually retains and pays for defense counsel for its policyholder, but the defense counsel's attorney/client relationship and duty of loyalty is unquestionably to the policyholder. States have adopted a variety of methods to address this potential conflict of interest between insurer-retained defense counsel and their clients, including the rules of professional responsibility for lawyers. In some instances insurers are required to pay for separate independent defense counsel selected by the policyholder. This requirement, adopted by common law in many states, is often referred to as the "Cumis" doctrine, after the California appellate court decision in *San Diego Federal Credit Union v. Cumis Insurance Society*, 162 Cal.App.3d 358 (Cal. App. 4 Dist. 1984). In contrast, state regulators and courts rarely address the inherent conflict in the producer commission structure involving brokers, clients and insurers.

Payment of contingent commissions is a long-standing practice in the U.S., and one that international brokers like Marsh became more aggressive in pursuing over the last decade. Although presumably insurance regulators were aware of this practice (particularly since many state insurance commissioners held senior positions in the industry prior to their public service), states did not ban or otherwise regulate contingent commissions and there was little controversy or discussion about the conflicts such schemes could generate for both independent agents and brokers.⁷ That is, until the fall of 2004.

In October 2004 New York Attorney General Eliot Spitzer filed the first in a series of lawsuits against brokers and insurers relating to contingent fee commissions, bid rigging and reinsurance transactions; the defendant was Marsh, then (and now) the largest broker in the world. Other states joined in and their investigations quickly encompassed the other leading brokers in the U.S., along with major commercial insurers.⁸

The complaints filed by the Attorneys General of New York, Connecticut and other states describe in detail the allegations and evidence demonstrating how contingent commission programs could warp the relationship between brokers and their cli-

ents, and link brokers and insurers to mutually lucrative compensation programs based on the amount and quality of business brokers placed with individual insurers.⁹ These allegations were strengthened by evidence demonstrating specific instances of "bid-rigging," where brokers and insurers colluded to provide false premium quotes ("B quotes" or "protective quotes") to broker clients, allowing brokers to steer their clients to specific insurers that would offer insurance at premiums lower than these B quotes.¹⁰ These bid-rigging complaints eventually proved limited to specific instances of misconduct and were not a general business practice between brokers and insurers,¹¹ but the fact they existed at all, and the explosive nature of the factual circumstances, as painstakingly laid out in the civil complaints, was widely publicized and enhanced the allegations and merits of the attorneys general lawsuits.

The initial round of state attorneys general lawsuits against brokers and insurers settled relatively quickly and by 2007 much of the public litigation had been resolved.¹² The settlement agreements required brokers and insurers to pay substantial fines, restitution to policyholders, and limitations or outright bans on using or paying contingent commissions in the future.¹³ An unusual feature in some of these settlements

⁷ New York was the one exception and required a written disclosure to the client of compensation received for placing insurance. New York Insurance Law § 2119

⁸ These investigations and prosecutions were usually led by state attorneys general offices rather than insurance regulators, a common occurrence in the U.S. where financial services regulators are often more cautious in pursuing questionable -and perhaps long-standing - practices than are state attorneys general, whose mandate is to enforce state consumer protection laws (often through litigation) rather than day-to-day prudential regulation. In the U.S. state attorneys general are almost always elected, and may come from a different political party than their state insurance commissioners. In New York and Connecticut the attorneys general are Democrats while their state insurance commissioners are appointed by their Republican governors. Thus in the U.S., insurance regulation is not only separated into over 50 jurisdictions, the enforcement of state insurance and consumer protections laws is often shared by state agencies that have different regulatory and political agendas.

⁹ The New York complaint is available at http://www.ag.ny.gov/media_center/2004/oct/oct14a_04.html. The settlement agreement between St. Paul Travelers and the states of Connecticut, Illinois and New York sets out these allegations quite clearly and is available at <http://www.ct.gov/ag/cwp/view.asp?A=2426&Q=318270>.

¹⁰ While there is legitimate disagreement whether contingent commissions violate state law, clearly bid-rigging, as described in these complaints, is illegal under state and federal law

¹¹ See Daniel Schwarcz, *Beyond Disclosure: The Case for Banning Contingent Commissions*, 25 *Yale Law and Policy Review* 289, note 3 (2007); Sean M. Fitzpatrick, *The Small Laws: Eliot Spitzer and the Way to Insurance Market Reform*, 74 *Fordham L. Rev.* 3041 (2006).

¹² But not all. For example, Connecticut Attorney General Richard Blumenthal continues to pursue insurers and brokers regarding contingent commissions, reinsurance programs and other insurer/brokers issues. In 2009 alone his office settled with Marsh (\$2.4 Million), The Hartford (1.3 Million), and Mutual of Omaha (1.7 Million). The Attorney General's webpage describes these actions and has links to complaints and settlement documents; available at <http://www.ct.gov/ag/site/default.asp>

¹³ The settlement with New York required Marsh to establish an \$850 Million settlement fund for Marsh's policyholder clients; Travelers paid a \$40 Million fine and established a \$35 Million settlement fund as part of its settlement with the attorneys general of Connecticut, Illinois and New York.

was requirements that the defendants support efforts to pass legislation banning or significantly limited the use of contingent commissions.¹⁴ These political efforts have largely been unsuccessful, at least as to substantive limitations. Accordingly, many brokers and agents continue to utilize and benefit from contingent commissions, though the largest brokers in the U.S., including Marsh, Aon, and Willis, are still unable to do so in many lines of insurance, such as commercial excess liability.

Numerous individual clients (policyholders), pension funds and other parties also filed civil lawsuits within weeks of Attorney General Spitzer's complaint, alleging that these compensation schemes violated various federal and state laws. The rush to litigation by private parties and their attorneys (or by plaintiff's attorneys and whatever clients they can hurriedly find) upon learning of government enforcement actions is typical in the U.S. and corporate defendants must often fend off multiple civil lawsuits and occasionally criminal charges as well.¹⁵ Many of these suits were consolidated into a single class action in 2005.¹⁶ In September 2009 settlements were confirmed with Zurich, which paid \$121,000,000 and broker Arthur J. Gallagher for \$28,000,000.¹⁷ In addition to these lawsuits attacking contingent commissions and bid-rigging, securities lawsuits were also filed against Marsh and other parties related to the precipitous drop in stock value some brokers suffered shortly after the New York Attorney General announced his first series of lawsuits.¹⁸ In mid-November 2009 Marsh announced a \$435 Million settlement in

a class action filed by numerous public and private investors, bringing its total settlements to date to over one billion dollars.¹⁹

The political discussion on how to regulate contingent commissions is often framed in terms of disclosure versus substantive limitations or outright prohibitions. This is a familiar debate in the U.S. whenever there are proposals to reform specific practices within the financial services industry. Over the last few decades most federal laws have required express disclosures to the consumer/client rather than limiting the substantive terms of the agreement.²⁰ Focusing solely on disclosure, however, does not resolve the inherent conflict between the broker's duty of loyalty to their clients and the significant financial incentives brokers receive for favoring certain insurers due to contingent fee arrangements, especially when written disclosures provided in fine print are contrasted with the (largely successful) public relations or marketing campaign insurance intermediaries have undertaken for decades in championing the consumer value of their independence.²¹ Further, the current financial crisis, particularly within the subprime mortgage market, has made general claims of industry self-regulation and regulation through disclosure more suspect.

While the actions of state attorneys general successfully ended, at least temporarily, the practice of contingent commissions by certain brokers and insurers in specific insurance lines (e.g., Marsh and excess liability), they have not succeeded in convincing state legislators or regulators to enact substantive li-

¹⁴ See paragraph 30 of the St. Paul Travelers settlement, note 9, *supra*.

¹⁵ When announcing its first lawsuit against Marsh in 2004, Attorney General Spitzer also disclosed that two insurance executives had just pleaded guilty to state criminal charges and were expected to cooperate in future investigations. In 2008 the federal government successfully prosecuted five senior executives from Gen Re and AIG for accounting fraud related to finite reinsurance transactions; these executives were sentenced to between one to two years in prison.

See <http://www.reuters.com/article/id USTRE58E4J320090915>

¹⁶ *In Re. Ins. Brokerage Antitrust Litigation*, 360 F.Supp.2d 1371 (Jud.Pan.Mult.Lit. 2005).

¹⁷ *In Re. Ins. Brokerage Antitrust Litigation*, 579 F.3d 241 (3d Cir. 2009). The plaintiffs' lawyers in the Zurich settlement received an additional \$25,000,000 in fees.

¹⁸ Within 4 days of the New York Attorney General filing his suit against Marsh in October 2004, Marsh stock dropped 50% and it lost \$9 Billion in capital within a week. *Sunday Business* (London), November 7, 2004, pg. C.13.

¹⁹ The settlement agreement is available at <http://www.insurancenewsnet.com/article.aspx?id=143385>.

²⁰ The classic example is the Federal Truth-in-Lending Law, 15 U.S.C.A. § 1601 et seq., which sets forth a precise methodology on calculating and disclosing annual percentage rates of interest, but does not limit the rate that can be charged. In contrast, state insurance regulation in the U.S. has traditionally focused on substantive protections and within personal lines there is still significant rate and form regulation.

²¹ See note 5, *supra*

mitations or prohibitions on the insurance producer community at large. Today, despite the public and private litigation described in this article, there are few restrictions on contingent commissions. Rather, the minority of states that have decided to regulate broker commissions at all have limited their involvement to client disclosures. In December 2005, fourteen months after New York Attorney General Spitzer filed his first lawsuit, the NAIC adopted new disclosure rules to its Producers Licensing Model Act. This new section requires insurance producers who represent the customer to disclose in writing the amount of compensation they receive from the insurer for placing that customer's business (or specific method of calculating the compensation) and receive an acknowledgement of that disclosure.²² This model law does not attempt to distinguish between brokers and independent agents and at least publicly there is little interest at the NAIC to proceed further in this area.

As tabulated by the NAIC, as of January 2008 only five states had adopted versions of Section 18 of the model act, seven more states have enacted their own disclosure requirements.²³ Accordingly, five years after the initiation of the New York/Marsh litigation, less than a quarter of the states have addressed contingent commissions through legislation or regulations. On December 2, 2009, however, the

New York Insurance Department issued a proposed regulation that would require insurance producers to disclose in writing whether it "represents the purchaser or the insurer for purposes of the sale," and the amount of compensation it will receive from the insurer if the insurance is purchased (stating, if relevant, that compensation will vary by the volume of business the producer provides to the insurer).²⁴ Within a day the Independent Insurance Agents & Brokers of New York threatened to sue the Department, alleging that it lacked statutory authority to compel these disclosures.²⁵

Prior to the 2008 financial services crisis, much of the discussion surrounding a federal regulatory role in insurance related to an "optional federal charter" which would allow insurers and insurance intermediaries to obtain a federal insurance license (not available currently) and avoid most State insurance regulation.²⁶ This legislation does not mandate producer compensation disclosures or limit or reference contingent fee commissions. Proponents were unable to move the legislation out of committee during the Bush Administration before the financial crisis hit, and it is even more unlikely the legislation will receive any significant support in its current form over the next several years.²⁷

²² NAIC Model Laws, Regulations and Guidelines 218-1 § 18. There are several major exceptions to this model act, including insurance producers whose sole method of compensation is from the insurer (218-1 § 18(A) (2)), or reinsurance intermediaries (218-1 § 18(C) (2)). The NAIC summarizes the "legislative history" or public comments received on its model laws; these summaries are available through the NAIC for a fee, or through LexisNexis.

²³ NAIC Model Laws, Regulations and Guidelines 218-1 § 18, State Adoption.

²⁴ New York State Insurance Department Proposed Regulation No. 194 (11 NYCRR 30), available at http://www.ins.state.ny.us/r_prop/pdf/rp194txt.pdf

²⁵ National Underwriter P&C, December 3, 2009 (IIABNY Threatens Suit over N.Y. Producer Comp Rule). An attorney for the New York Insurance Department stated the Department was surprised producers should object to disclosing who they represent in a transaction: "For years the Big I [Independent Agents and Brokers of America] have said they are the 'Trusted Choice' for consumers; what they apparently don't want to tell their customers is that in most transactions, they represent the insurance industry." *Id.* This statement nicely summarizes the potential conflict of interest between insurance producers and clients, and questions of independence, consumer expectations, and insurer compensation.

²⁶ The most recent iteration of an optional federal charter bill is House Resolution 1880, the "National Insurance Consumer Protection Act." This legislation was introduced in Congress on April 2, 2009 and has not moved out of committee since. The text, summary and current status of any federal legislation can be easily searched through the Library of Congress' website, <http://thomas.loc.gov/>.

²⁷ The NAIC, other state regulatory organizations, some insurance intermediary trade groups, and many small to medium size insurers have vigorously opposed this legislation. Their opposition remains and the now highly public failures of federal regulators to properly oversee federally-chartered financial services institutions makes it unlikely they will receive any significant supervisory authority over the one financial services sector in the U.S. that remains largely healthy and under the apparently effective (if often inefficient) regulation of the states. However, in contrast to this opinion, Representative Barney Frank of Massachusetts was quoted in early December as stating that optional federal charter legislation "remains on the table." National Underwriters P&C, December 2, 2009 (U.S. Insurance Office Bill Passes House Committee).

More likely is the creation of a federal agency that would have little supervisory authority, but would monitor the insurance marketplace, collect and analyze information, coordinate with state insurance departments, and negotiate on behalf of the U.S. with insurance regulatory agencies outside of the country, with some ability to preempt state insurance laws where inconsistent with international treaty obligations in this area. President Obama's draft legislation last spring to modernize financial services regulation included the creation of the "Office of National Insurance" and would have accomplished these goals which, however modest they seem to regulators outside the U.S., would have been the most significant assertion in U.S. history of a federal role in insurance regulation.²⁸ However, the Administration's overall regulatory modernization plan is strongly opposed by much of the financial services industry and affected regulators, and a modified version passed the House on December 11, 2009.²⁹ The legislation includes a "Federal Insurance Office," which while not figuring significantly in public debate, was watered down from the President's proposal. This Act retains the information collection function of the proposed federal insurance agency, but places additional limitations on the already modest insurance preemption provisions in the President's draft.³⁰

Three years ago producer compensation and concern over conflicts of interest between intermediaries, insurers and policyholders were a major source of legal, regulatory and political attention. While the public and private litigation filed in 2004 and 2005 is still winding down, these issues have been overtaken in the U.S. by broader concerns of financial services regulatory reorganization, as well as health care and health insurance reform. Neither of the two proposals for a federal insurance office reference producer compensation, nor provide authority for the federal agency to regulate this area. However, as discussed earlier in this paper, in the first week of December

2009 New York released its draft regulation of producer compensation which if enacted would regulate this subject more aggressively than the NAIC model act. Absent the unexpected passage of an optional federal charter bill, this area will continue to be regulated at the discretion of the individual states over the next several years.

CHINA

In China, the definition of an insurance broker differs substantially from that of other jurisdictions and it is necessary to carefully define how intermediaries are covered by this section. Under Chinese law, there are two types of insurance producers, the agent, and the broker. An insurance agent "acts upon the insurer's instruction, collects commissions from the insurer, and transacts insurance business within the authority given by the insurer."³¹ An insurance broker is one who "for the benefits of the applicant, provides intermediary services to the applicant and the insurer for the purpose of entering into insurance contracts, and collects commissions pursuant to the law."³² Notable in the broker's provision is that a broker is *not* defined as "the agent of the applicant/insured." The law indicates only that the broker negotiates for the *benefit of the applicant*. In addition, the broker may be remunerated by either the insurer *or* the insured. Chinese lawmakers allow the adjudicator to determine which interest the broker represents upon consideration of the actual details surrounding the business relationship, recognizing that in practice there are multiple factors relevant to this determination.

Anglo-American insurance law uses a similar pragmatic approach: when a broker is filing an application on behalf of the applicant, he or she is the agent of the applicant; an applicant's statements may not necessarily be considered a formal admission to the insurer. However, when the same broker collects premiums from the insured, he or she may be deemed an agent of

²⁸ "Financial Regulatory Reform: A New Foundation," Title V. See <http://treasury.gov/initiatives/regulatoryreform/>

²⁹ Passed as the "Wall Street Reform and Consumer Protection Act of 2009," House Resolution 4173. This legislation moves to the Senate for consideration, where substantial revisions may occur.

³⁰ State insurance laws would only be preempted if they treated a non-U.S. insurer less favorably than a domestic insurer, and was also inconsistent with international insurance treaties concerning prudential supervision. H.R. 4173, Section 8002(f).

³¹ Art 117, Insurance Law of the People's Republic of China (revised at the 7th Session of the Standing Committee of the Eleventh National People's Congress on February 28, 2009).

³² *Id.* at Art 118.

the insurer. In this case, undisputed acceptance of overdue payment may constitute the insurer's waiving the right to challenge the validity of the policy.³³ In these regards, Chinese intermediary law is consistent.

There are three types of insurance agents in China: (1) individual, (2) corporate "dedicated", and (3) institutional "non-dedicated" agents.³⁴ Individual agents are licensed professional producers selling policies under their own name, without utilizing a corporate structure. Individual agents can represent no more than two life insurers at any particular moment;³⁵ for other forms of insurance ("non-life business") there is no limitation on the number of insurers. Corporate agents are licensed professionals who transact under the protection of a corporate status. The distinction between "dedicated" and "non-dedicated" agents is determined by whether the agent's sole business is insurance ("dedicated") or whether the agent sells other products as well ("non-dedicated"). Non-dedicated agents are required to transact business under an institutional basis as a commercial entity, though incorporation is not required.

The category of corporate non-dedicated agents includes organizations such as banks, post offices, car dealers, and travel agencies. Corporate dedicated agents may represent as many insurers as they wish, regardless of whether they are selling life or non-life products. In contrast, the number of insurers a non-dedicated agent may represent depends on its capitalization, size of distribution network, number of qualified practitioners, internal governance, and even its Information Technology infrastructure.³⁶ Those agents who are considered to fully satisfy these requirements can represent an unlimited number of insurers in any line of business ("Grade A" non-dedicated agents); agents who meet the next level of requirements can represent up to five insurers ("Grade B"); and agents who meet the lowest level of requirements can represent only one insurer ("Grade C").³⁷ As for insurance brokers, they must be incorporated and dedicated to the brokerage business; there is no limita-

tion on the number of representation, and they can broker both direct business and reinsurance.

The Chinese classification of insurance agents is based primarily on organizational structure rather than the substance of their transactions. Setting formalism aside, those individual agents, corporate dedicated agents and institutional non-dedicated agents who represent only one insurer are in fact captive agents in the Western sense. Other agents, whether individual, incorporated or unincorporated, who represent multiple insurers are, by Western standards, independent insurance agents. They have a non-exclusive relationship with their insurer principals, and the capability to place an applicant's order with insurers at their choice. Chinese brokers, on the other hand, are all incorporated insurance intermediaries.

Conflict of interest normally arises in the broker setting, as they often receive compensation from the insurer while representing the interest of the other party, the insured. This dual agency relationship frequently compromises brokers' integrity. By way of comparison, captive and independent agents rarely face such a conflict as they are solely remunerated by the insurers, and they owe their loyalty to the insurer only.

As discussed above, in the brokerage industry, the practice of rewarding brokers with insurers' commission payment has generated a real risk of conflicting interests. Although contingency commissions have not been a widely-used practice in the Chinese market, insurers do pay out various percentages of the premiums written to the brokers who place orders with them, and perhaps other benefits as well. It is not surprising that brokers always have incentives to steer customers' orders to those insurers who pay the highest commission and/or benefits. Under normal circumstances, neither the broker nor the insurer will voluntarily disclose their commission arrangement to the policyholder, and the latter is unaware of the potential or even actual conflict of interest triggered by this arrangement. The same problem also manifests in the fee-based consultancy service when customers hi-

³³ See Robert Jerry & Douglas Richmond, *Understanding Insurance Law*, 4th ed., LexisNexis 240—241 (2007).

³⁴ Art 117, *supra* note 31.

³⁵ *Id.* at Art 125.

³⁶ Art 13, 16 and 17, Experimental Regulatory Measures on Institutional Non-dedicated Insurance Agents, promulgated by Order No. 109 [2006] of China Insurance Regulatory Commission (October 24, 2006).

³⁷ *Id.* at Art 39.

re brokers to design their insurance programs; what the customers get may be a program generating the highest commissions for the broker, rather than a program that will best suit their insurance needs.

To tackle this problem, the China Insurance Regulatory Commission (CIRC), the exclusive insurance regulator in this country, promulgated a set of revised rules on brokerage firms at the end of September, 2009. Under these new rules, brokers are required to produce a written disclosure to their customers, stating: (1) contact information for the brokerage firm, (2) the affiliation, if any, between the firm (or directors and/or officers of the firm) and the particular insurer in this transaction, (3) the percentage and method of commission payments the broker will receive as commission, if so requested by the customer, and (4) the name of the insurer the broker placed the order with, and a "comprehensive and unbiased" analysis of the comparable insurance products offered by other insurers.³⁸ Moreover, pursuant to another set of rule governing insurers' usage of intermediaries published on the same date, insurers have to record the premiums that they receive from and the commissions that they pay out to each broker in each transaction;³⁹ any other undocumented benefit payable to brokers is forbidden.⁴⁰

The stance taken by the Chinese regulator favors disclosure rather than strict prohibition as the appropriate means to mitigate this risk of conflicting interests. The disclosure requirements are stringent and include details of commission arrangements as well disclosing interlocking directorships involving brokers and insurers, even though interlocking directorship is a much more indirect and remote source of conflict. These requirements will be an important test of the duty of loyalty brokers owe their customers. The ban on hidden rebates or commissions will more likely than not make contingent commission payments more difficult. If such payment schemes do gain popularity among Chinese insurers in the future, such plans will have to be transparent.

However, a closer scrutiny suggests that there are two conditions precedent to the effectiveness of this disclosure strategy. The first condition is that insurance consumers need to be well informed and educated about their right to information, because the disclosure of commission arrangement is not automatic but "upon request"⁴¹. It is unrealistic to expect that brokers will volunteer this most important information to unsophisticated policyholders. Second, the regulator needs to make significant efforts to enforce the ban on hidden rebates or commissions, because this ban is a regulatory compliance requirement rather than a consumer right. The commission payment record is not a part of the written disclosure provided to customers, but a regulatory compliance obligation, which means only the regulator has access to these records. If the regulator does not watch carefully, policyholders or consumer protection groups will not be able to detect irregularity.

Two findings are raised by recent developments in insurance regulation in the US and China. The first is that conflict of interests arising from these compensation schemes affect not only brokers, but also independent agents which are involved in insurance distribution either as their own main (sole) business, or as their side business. The second is that the chosen regulatory solution to this conflict is compensation disclosure; instead of banning contingent commissions, regulators have established requirements for the broker to communicate to customers the amount of its commission. This obligation, however, arises only if the client expressly requests the intermediary provide this information.

THE EUROPEAN UNION

How are these regulatory approaches in the U.S. and China reviewed in the ongoing debate in the European Union on the adoption of amendments to Directive 2002/92/EC on insurance mediation? The current EU framework for considering insurance intermediaries' conflicts of interest is in Article 12 of this Directive⁴². Some of the rules set by this article

³⁸ Art 37, Regulatory Measures on Insurance Brokerage Institutions, promulgated by Order No. 6[2009] of China Regulatory Insurance Commission (September 25, 2009).

³⁹ Art 4, para 2, Disciplinary Actions against Illegal Dealings with Intermediaries Committed by Insurance Companies, promulgated by Order No. 4[2009] of China Regulatory Insurance Commission (September 25, 2009).

⁴⁰ *Id.* at Art 10.

⁴¹ Art 37, *supra* note 38.

⁴² Directive 2002/92/EC on insurance mediation became effective on 15 December 2005 and contains a definition of "insurance intermediary" (defined in Art. 2 as follows: "Any natural or legal person who, for remuneration, takes up or pursues insurance medi-

are intended to provide the customer with information related to the insurance intermediary, in particular its relationship to the insurers. Therefore, in instances where information is to be provided solely at the customer's request, the customer should be informed he has the right to request such information. According to these provisions, prior to the conclusion of any initial insurance contract, and, if necessary, upon amendment or renewal, an insurance intermediary shall provide the customer with certain information, including whether either the intermediary or the given insurance undertaking have 10% or more of the voting rights or capital in the other entity. In addition, an insurance intermediary shall inform the customer whether: (i) he gives advice based on the obligation to provide a fair analysis, or (ii) he is under a contractual obligation to conduct insurance mediation business exclusively with one or more insurance undertakings (and, at the customer's request, shall provide the names of those insurance undertakings, or (iii) he is not under a contractual obligation to conduct insurance mediation business exclusively with one or more insurance undertakings and does not give advice based on the obligation to provide a fair analysis. In that case, at the customer's request the intermediary shall provide the names of the insurance undertakings with which he may and does conduct business.

Article 12 is also concerned with the proposed contract between the customer and the intermediary;⁴³ this section likely also reflects concerns with conflicts of interest, though it is not explicitly referred to. The principle they establish, in fact, is that the contract proposed by the intermediary to the customer must meet the needs of the latter. Therefore, we can say that an insurance intermediary's conflicts of interest: (i) must be communicated to the customer, and (ii) cannot override the requirements that the customer obtain a contract that meets its insurance needs. It is important to add, however, that the information referred to above need not be given when the insurance intermediary is involved in obtaining insurance for large risks, nor for reinsurance intermediaries (see Art. 12, par. 4)⁴⁴.

Going to the conclusion, the EU regulatory framework does not specifically regulate intermediary compensation, even though this issue has received much attention in the U.S. and China. Article 12 of the Directive 2002/92/EC does allow Member States to maintain or adopt stricter provisions regarding the information requirements relevant to conflicts of interest - provided that such provisions comply with Community law⁴⁵ - thereby forgoing, however, the goal of creating a harmonized regulatory framework that is functional to a Single Market⁴⁶.

ation") and "insurance mediation" (in this respect, Art. 2 sets out: "Means the activities of introducing, proposing or carrying out other work preparatory to the conclusion of contracts of insurance, or of concluding such contracts, or of assisting in the administration and performance of such contracts, in particular in the event of a claim"), but not one of an "insurance broker".

However, according to Article 2 of the Directive 92/77/EEC of 13 December 1976, which was repealed through the Directive 2002/92/EC, a broker is (: was) defined as follows: "Professional activities of persons who, acting with complete freedom as to their choice of undertaking, bring together, with a view to the insurance or reinsurance of risks, persons seeking insurance or reinsurance and insurance or reinsurance undertakings, carry out work preparatory to the conclusion of contracts of insurance or reinsurance and, where appropriate, assist in the administration and performance of such contracts, in particular in the event of a claim."

⁴³ Prior to the conclusion of any specific contract, the insurance intermediary shall at least specify, in particular on the basis of information provided by the customer, the demands and the needs of that customer as well as the underlying reasons for any advice given to the customer on a given insurance product. These details shall be modulated according to the complexity of the insurance contract being proposed.

⁴⁴ According to Recital 21 of the Directive there is less of a need to require that such information be disclosed when the customer is a company seeking reinsurance or insurance cover for commercial and industrial risks.

⁴⁵ In this regard, see: Commission Interpretative Communication, *Freedom to provide services and the general good in the insurance sector*, in OJEC, 2000/C43/03.

⁴⁶ Consequently, each EU member State is free to give a definition of broker and rules governing their professional requirements. Art. 3 Directive 2002/92/EC requests that: "1. Insurance and reinsurance intermediaries shall be registered with a competent authority as defined in art. 7(2), in their home Member State. 2. Member States may establish more than one register for insurance and reinsurance intermediaries provided that they lay down the criteria according to which intermediaries are to be registered". In addition, art. 4 Directive 2002/92/EC fixes as Professional requirements: (i) Insurance and reinsurance intermediaries shall possess appropriate knowledge and ability, as determined by the home Member State of the intermediary; (ii) Insurance and reinsurance intermediaries shall be of good repute."

The European Commission launched in 2005 a Sector inquiry on business insurance⁴⁷, ending in 2007⁴⁸, that has also affected brokers' compensation. The findings of the Inquiry were summarized by the Commission,⁴⁹ which considers that disclosure of relevant information by intermediaries, in relation to remuneration received from insurers and services provided to insurers, may help mitigate conflicts of interest.

At present, even where disclosure takes place, it is not always complete, clear and understandable to the client. In the light of similar situations that arise in other financial sectors, notably securities and banking, it is questionable if disclosure alone is sufficient to mitigate conflicts of interest, particularly in compensation programs designed to align the interest of brokers with that of insurers.⁵⁰ The Inquiry pointed out that the competitive market dynamics in pricing mediation services appear limited, as far as small-medium enterprise (SME) clients are concerned. In the Commission's opinion the seemingly low concern of SME clients with the price of insurance mediation services may be due to a common misconception as to the amount of commission (and possibly other types of remuneration) paid to the intermediary which is included in their insurance

premium, and which is typically higher than is realized.⁵¹ The Commission believes that this issue, although potentially leading to serious concerns of market distortion, has multiple dimensions which require careful consideration. It intends to look at the issue in the framework of the planned review of the Directive 2002/92/EC, without at this stage prejudging whether this is the most appropriate way to address it. When considering this issue, the Commission will also review the treatment given to similar situations in other financial sectors, in particular the Market in Financial Instruments Directive (MiFID) regime for investment services⁵², in order to ensure regulatory neutrality.⁵³

A premise is necessary, however, before we take a look at the solutions adopted by the MiFID⁵⁴. That Directive involves investment services where the investment risk is borne by the investor, unlike insurance which aims – normally - to transfer risk (its economic consequences) from the insured to the insurer. In principle, therefore, the treatments adopted for the investment services are certainly applicable to insurance where the risk is borne by the insured, for example the unit linked policies⁵⁵. However, more analysis is necessary to ensure that these solutions are most effective when the risk is

⁴⁷ The definition of "Business insurance" adopted by the *Inquiry* is as follows: "The provision of insurance products and services to any type of business, irrespective of its size, form of organization or legal structure."

⁴⁸ An *Interim* report has been published on January 2007 (available on http://ec.europa.eu/comm/competition/sectors/financial_services/inquiries/interim_report_24012007.pdf), followed by the Final report on October 2007 (available on http://ec.europa.eu/comm/competition/sectors/financial_services/inquiries/final_report_annex.pdf).

⁴⁹ See the Communication from the Commission COM(2007) 556 final (available on <http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0556:FIN:EN:PDF>).

⁵⁰ See point 22 COM(2007) 556 final.

⁵¹ See point 25 COM(2007) 556 final.

⁵² This directive is a key part of a package of European Union laws aimed at creating a single, more competitive market in financial services across all EU member states. In particular, MiFID aims to harmonize the rules governing the activities of financial services firms, to promote easier cross border business, increase market transparency and improve investor protection. It replaces the Investment Services Directive (ISD), which has been in place since 1995.

⁵³ See point 26 COM(2007) 556 final.

⁵⁴ MiFID has been developed according to the Lamfalussy process which is an approach to the development of financial service industry regulations used by the European Union. It is composed of four "levels", each focusing on a specific stage of the implementation of legislation. At the first level, the European Parliament and Council of the European Union adopt a piece of legislation, establishing the core values of a law and building guidelines on its implementation. In the case of MiFID, this first level is the Directive 2004/39/EC. The law then progresses to the second level, where sector-specific committees and regulators advise on technical details, then bring it to a vote in front of member-state representatives. In regards to MiFID, the second level is Directive 2006/73/EC. At the third level, national regulators work on coordinating new regulations with other nations. The fourth level involves compliance and enforcement of the new rules and laws. A scheme of the Lamfalussy model in the insurance sector is available in CEPS TASK FORCE, *The Future of Insurance Regulation and Supervision in the EU. New Developments, New Challenges*, Brussels, November 2006, p. 139.

⁵⁵ Unit linked insurance policy is a life insurance policy which provides a combination of risk cover and investment. The dynamics of the capital market have a direct bearing on the performance because the investment risk in investment portfolio is borne by the policy holder. Therefore, depending upon the performance of the unit linked fund(s) chosen, the policy holder may achieve gains or losses on his/her investments.

transferred to the insurer, despite the alleged conflict of interest of the broker.

Article 19, par. 1, of the Directive 2004/39/EC of the MiFID establishes the principle that an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients when providing investment services. This principle is implemented by Article 26 of the Directive 2006/73/EC prohibiting investment firm from paying or receiving any fee, commission or non-monetary benefit with three exceptions. In particular, Article 26, let. b), allows fees, commissions or non-monetary benefits paid or provided to or by a third party where the following conditions are satisfied: (i) the existence, nature and amount of the fee, commission or benefit, or where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service; (ii) the payment of the fee or commission, or the provision of the non-monetary benefit must be designed to enhance the quality of the relevant service to the client and not impair compliance with the firm's duty to act in the best interests of the client.

Indeed, Article 21 of the Directive 2006/73/EC regulates conflicts of interest that pose potential detriments to clients. Member States shall ensure that investment firms take into account, by way of minimum criteria, the question of whether the investment firm or a relevant person is in the situation – among others – in which the firm or that person receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of monies, goods or services, other than the standard commission or fee for that service. Based on this framework, the conclusion is that contingent commissions are not prohibited by MiFID, if certain conditions occur and investment firms manage the conflict of interest without damaging their (in-

formed) clients. Therefore, the solution is similar to that emerging in the U.S. and China, which center on disclosure rather than banning contingent commissions, although the MiFID more carefully regulates these commissions.

Assuming Directive 2002/92/EC on insurance mediation implements these solutions, it is clear that: (i) the risks covered by business insurance do not coincide with the risks taken into account by this Directive, which exclude large risks⁵⁶; (ii) with reference to the mass risks⁵⁷, the Directive does not distinguish life insurance, although some policies do not guarantee the amount of benefit thus retaining the investment risk borne by the insured. Therefore, the amendments to the Directive 2002/92/EC should extend its scope to include large risks, if the EU Commission wants to resolve the conflict of interest of brokers that emerged in the abovementioned Inquiry on business insurance by applying MiFID' solutions. In this case, however, the EU Commission should distinguish between the rules in relation to the type of customers and whether the insurance product is comparable to a financial product for its features. MiFID, in fact, distinguishes between professional clients and retail clients,⁵⁸ in accordance with their skills and needs of protection, providing protection primarily to retail clients to which all the rules set out above are applicable.

The U.K.'s Financial Services Authority (FSA) conducted a survey that provides useful support in distinguishing the rules applicable to conflicts of interest for brokers.⁵⁹ According to the FSA's findings, the disclosure of contingent commissions should be introduced for commercial customers, while the disclosure is useless for retail customers because their insurance needs are standardized and their choice is determined mostly by lower insurance premiums which are obtained through competing intermediaries. Following the FSA's perspective, then, the conflict of interests of brokers could be neutralized to the retail customers by

⁵⁶ According to Article 2, n. 8 of the Directive 2002/92/EC, "large risks" shall be as defined by Article 5(d) of Directive 73/239/EEC.

⁵⁷ "Mass risks" are all risks not included in the definition of "large risks", although included in the Annex A of the Directive 73/239/EEC.

⁵⁸ See art. 1, n. 10), 11) and 12) of the Directive 2004/39/EC for the definition of "client", "professional client" and "retail client".

⁵⁹ FSA, *Transparency, disclosure and conflicts of interest in the commercial insurance market*, December 2008, available at: http://www.fsa.gov.UK/pages/Library/Policy/DP/2008/fs08_07.html.

ensuring competition between these intermediaries. These findings, however, cannot be generalized. We pointed out before that the characteristics of some life insurance products are very similar to those of financial products, if not identical. In this case, the competition on the insurance premium does not seem relevant for an effective regulation of the conflict of interest, because the policyholder bears the investment risk. Therefore the solutions offered by MiFID appear more effective to ensure the protection of retail customers, when the insurance products are "financial". Moreover, this regulatory neutrality would discourage regulatory arbitrage between different "financial" sectors, which may arise, e.g., by "dressing" financial products as insurance products.

In the U.S. and China, however, the conflict of interest problems with brokers are similar to those of independent agents. At least in principle, regulatory solutions should be identical between these intermediaries. Moreover, leveling the playing field among intermediaries requires addressing the substance of the relationship between intermediaries and their clients. Banks, for example, should be subject to the same rules as investment services when they distribute insurance products which are financial products, but bank commission structures would be subject to the problem of "free riding" towards their customers when they distribute insurance products other than "financial." Banks, in fact, often have a different relationship with their customers, which are "preliminary" to the insurance relationship, in that they usually have a preexisting business relationship. Therefore, a bank's commission structure could, as with other insurance intermediaries, align a bank's financial interests to the insurers, while its customers would trust the advice they receive from their bank or find it difficult to reject these proposals because of other relationships, such as credit extensions. In principle, regulation intended to protect policyholders should identify and regulate insurance intermediary conflicts of interest in a similar manner regardless of the nature of the intermediary. Therefore, further discussion is necessary for banks as it seems their potential conflicts of interest create additional concerns.

SUMMARY

All three regulatory jurisdictions have recently considered the issue of broker compensation and the potential conflicts of interest between broker and client that insurer-based compensation schemes can engender.

In the U.S., the primary response has been litigation filed by both public entities (states) and private parties against the country's largest brokers and commercial insurers. While these suits have resulted in billions of dollars in fines and restitution, they have not succeeded in banning contingent commissions, and at the end of 2009 fewer than 25% of the states have even mandated new commission disclosure requirements. With the country's current political focus on health reform and financial services modernization, this issue has captured little legislative attention over the last year and none of the 2009 legislative proposals to establish a federal office of insurance address broker conflicts of interest.

The Chinese insurance regulatory authority, SERC, adopted new requirements in fall 2009 requiring specific compensation disclosures and clear identification of the insurer. However, this information is only provided if the client requests it, and the prohibition on hidden rebates or commissions can only be reviewed and enforced by the regulator. The fluid nature of the Chinese insurance marketplace also makes it difficult to enforce disclosure and compensation requirements.

The EU has studied the issue of broker conflicts of interest and insurer-based compensation schemes through the 2005 Sector inquiry on business insurance, which issued its report in 2007, but the EU has not yet taken a formal position. The Commission is proceeding cautiously and reviewing how this issue is addressed in regulating similar industries, such as investment services through the MiFID.

All three jurisdictions have focused on disclosure as the preferred regulatory solution to potential conflicts of interest rather than substantive limitations, such as banning contingent commissions outright or restricting their use; while none of the jurisdictions appear to take into consideration additional issues that arise for independent agents, in particular banks.