CA COMMENTS 7.22.19

California's Comments in bold/blue text

Chapter 6

Prelicensing Education

Prelicensing education is required in some states as a condition of licensure for resident insurance producers. Neither the PLMA nor the ULS suggests that a state must have a requirement for prelicensing education. States that have a prelicensing education requirement should follow the uniform standards as adopted by the Producer Licensing (EX) Working Group.

The ULS set a minimum credit hour requirement for prelicensing education. In 2010, the Producer Licensing (EX) Working Group was charged with reviewing this standard. Updated information, if there are any changes to this standard, can be found on the Producer Licensing (EX) Working Group's web page.

States that require prelicensing education shall require 20 credit hours of prelicensing education per major line of authority. States must accept both classroom study and verifiable self-study, which includes both text **[please define "text" for self-study]** and online courses. The ULS does not have a limit on the number of credits that can be obtained by self-study. States shall independently determine the content requirements for prelicensing education. The ULS require that a state have a method to verify completion of prelicensing education, but they do not prescribe a method.

The ULS provide that a person who has completed a college degree in insurance shall be granted a waiver from all prelicensing education requirements. The ULS also provide that individuals holding certain professional designations approved by the insurance department should be granted a waiver from the prelicensing education requirement. In 2008, the ULS were updated to indicate the following list of designations be provided as guidance for designations that would waive prelicensing education, but the list is not exhaustive:

Life: CEBS, ChFC, CIC, CFP, CLU, FLMI, LUTCF

Health: RHU, CEBS, REBC, HIA

P/C: AAI, ARM, CIC, CPCU

Under both reciprocity standards and the ULS, no state shall require prelicensing education for nonresident applicants or nonresident producers who change their state of residency.

Chapter 7

Application Review for Initial Licenses

Individual Application Forms

The Producer Licensing (EX) Working Group adopted a uniform application, and the ULS require its use for all producer applicants. Section 6 of the PLMA outlines the process a state is to follow in reviewing the application and in making the determination as to whether to grant a resident producer license.

Before issuing a resident producer license to an applicant, the state must find that an applicant for a resident license:

1. Is at least 18 years of age.
2. Has not committed any act that is a ground for denial, suspension or revocation set forth in the PLMA Section 12.
3. Where required by the insurance commissioner, has completed a prelicensing course of study for the lines of authority for which the person has applied.
4. Has paid the appropriate fees.
5. Has successfully passed the examinations for the lines of authority for which the person has applied. Note that the ULS provide that examinations are not generally required for limited lines, but that it is acceptable for examinations for areas such as crop and surety.

Business Entity Applications

The following requirements are optional and would apply only to those states that have a business entity license requirement.

The Producer Licensing (EX) Working Group adopted a uniform application form for business entities, and the ULS require its use. Section 6 of the PLMA requires that before approving an application for a resident business entity, the state shall find that:

1. The business entity has paid the appropriate fees.
2. The business entity has designated a licensed producer responsible for the business entity's compliance with the insurance laws, rules and regulations of the state.

Section 6 also gives the insurance commissioner authority to require any documents necessary to verify the information contained in an application. In 2010, the Producer Licensing (EX) Task Force considered methods to expedite and streamline business entity licensing. Updated proposals can be found on the Producer Licensing (EX) Working Group Producer Licensing (EX) Working Group's web page.

Background Checks

The GLBA allows states to perform criminal background checks on resident applicants. The ULS contain guidelines on how to perform background checks, including the following three-step process for background checks:

A. States will ask and review the answers to the standard background questions contained on the Uniform Applications;

B. States will run a check against the NAIC Regulatory Information Retrieval System (RIRS)/SPLD and 1033 State Decision Repository (SDR) – Data Entry Tool; and

C(1) States will fingerprint their resident producer applicants and conduct state and federal criminal background checks on new resident producer applicants; or

C(2) If a state lacks the authority or resources to accept and receive data from the Federal Bureau of Investigation (FBI), it shall conduct a statewide criminal history background check through the appropriate governmental agency for new resident producer applicants until such time as it obtains the appropriate authority.

Fingerprints

Under the ULS, the goal is that all states will electronically fingerprint their resident producers as part of the initial resident producer licensing process. States that lack the authority to run criminal history background checks through the FBI are encouraged to at least run a statewide background check until such time that state and national fingerprinting is implemented.

The Producer Licensing (EX) Working Group adopted model language that will allow a state to access federal databases. (See the *Authorization for Criminal History Record Check Model* [*#222*].) States are encouraged to adopt this language.

1033 Consent Waivers [Are there state guidelines for the 1033 waivers (e.g., standards for the 1033 review/waiver?]

The Violent Crime Control and Law Enforcement Act of 1994, 18 U.S.C. §§ 1033 and 1034, commonly referred to as "1033," establishes a ban on individuals who have been convicted of certain felony crimes involving dishonesty or breach of trust from working in the insurance business. The law provides that a banned person can apply to the state insurance commissioner for a written consent to work in the insurance business. If an individual with a felony involving dishonesty or breach of trust obtains a 1033 consent waiver from that person's resident state, the person cannot be prosecuted for engaging in the business of insurance in violation of 18 U.S.C. §§1033 and 1034.

When one state grants a written consent waiver to an individual pursuant to 18 U.S.C. §1033, the consensus of legal opinion is that this written consent waiver is effective nationwide.

The Producer Licensing (EX) Working Group determined that the resident state bears responsibility for consideration of applications for consent waivers. Nonresident applicants should not be subject to additional procedures, nor should producers seeking nonresident licenses have to go through the 1033 process in all states after the producer's resident state has issued a waiver. However, producers who have received waivers are required to attach them to applications for nonresident licenses. To assist these applicants, states should include a specific reference to 18 U.S.C §1033 within the text of the document that grants a waiver. States may exercise their discretion to deny licenses based on the types of criminal convictions disclosed in consent waivers. The NAIC Antifraud (D) Task Force adopted guidelines for review and granting of these consent waivers. Under the guidelines, states are to report all activity on these consent waivers to the (1033 SDR – Data Entry Tool). The full text of the guidelines is available through I-Site.

NAIC Databases Relevant to Initial Application Review

The NAIC maintains three databases that should be consulted as part of application review.

1. The Complaint Database System (CDS) contains information on closed complaints as reported by the states.
2. The RIRS contains any action taken by a state insurance department where the action is against an entity and where the disposition is public information. All final adjudicated actions taken and submitted by a state insurance department are reflected in the RIRS. The information typically includes: administrative complaints, cease and desist orders, settlement agreements and consent orders, receiverships, license suspensions or revocations, corrective action plans, restitutions, closing letters, and letter agreements. The RIRS does not include exam report adoption orders without regulatory actions.
3. A record of 1033 actions is maintained in 1033 SDR – Data Entry Tool. The 1033 State Decision Repository (SDR) application allows regulators to enter and search for 1033 decisions (approved or denied), which state regulators have made for individuals who requested to work in the business of insurance but who have been prohibited to do so by section 1033 of the Violent Crime Control and Law Enforcement Act of 1994.

Review of Applications When Criminal History is Disclosed

As part of the 2009 charges for the Producer Licensing (EX) Working Group, the Producer Licensing (EX) Task Force asked the Producer Licensing (EX) Working Group to develop uniform guidelines for background check reviews of producers. For all jurisdictions to have a comfort level with licensing determinations made by a resident state when the applicant has a criminal history, a uniform process of review is warranted. If all jurisdictions implement these guidelines, in most situations, nonresident states will be able to defer to the resident state's licensing decision. A copy of the Uniform Criminal History and Regulatory Actions Background Review Guidelines is included in the Appendix of this Handbook.

When an application contains a disclosure with a "yes" answer to a criminal history question, in determining whether to issue a license, states should consider the following factors:

- *Resident vs. Nonresident*

If the application is for a resident producer license, it is incumbent upon the resident state to scrutinize all "yes" answers on the application and to request and obtain documentation and a detailed explanation for all criminal charges. Nonresident applicants' criminal histories also should be documented and explained with consideration given the fact that the resident state already has issued a license to the applicant.

- *Severity and Nature of the Offense*

Felony convictions should always be considered in determining whether to issue a license to an individual and may require the applicant to apply for a 1033 consent waiver prior to application. (See the section on 1033 consent waivers.)

A criminal conviction is only relevant to the licensing decision if the crime is related to the qualifications, functions or duties of an insurance producer. Examples include theft; burglary; robbery; dishonesty; fraud; breach of trust or breach of fiduciary duties; any conviction arising out of acts performed in the business of insurance; or any actions not consistent with public health, safety and welfare. Special scrutiny should be given to financial and violent crimes.

- *Frequency of Offenses*

While a producer's past criminal history is a red flag and may be a predictor of future behavior, the frequency of offenses should be considered, with more weight given to a pattern of illegal behavior than to a one-time minor indiscretion.

- *Date of the Offense*

The application form requires the applicant to disclose all criminal charges, except minor traffic offenses. A reviewer should consider when the offenses occurred and the age of the applicant at the time of the offense.

- *Completion of Terms of Sentencing*

Applicants should provide evidence that they have completed all the terms of their sentences, including paying restitution, or completing any probationary periods or community service.

- *Evidence of Rehabilitation*

The applicant should be required to provide evidence of rehabilitation. Completion of the terms of sentencing alone does not demonstrate rehabilitation. A state may request a statement from the applicant's probation officer or other appropriate official.

Statutory Obligations and Discretion

Insurance regulators should review state law to determine guidelines for approval or denial of the application. After consideration of the above factors, the insurance regulator has several options:

1. Request additional information or documentation.
2. If the producer failed to report an action, contact the producer and request an explanation from the producer. (Technical violations, such as bad address or failure to timely report, generally do not merit formal action. However, the failure to report an action in itself can be cause for administrative penalty or a warning letter, depending on the particular state's law).
3. Approve the application with no conditions.
4. Approve the application with conditions.
5. Deny the application.

In some cases, it may be appropriate to grant a conditional license. This option may not be available in all states and may be limited by state law or regulation. Some options include:

1. Issue a probationary license that will expire after six months or a year, or that will coincide with the applicant's criminal probationary period. At the end of the probationary period, and prior to consideration of full licensure, the insurance regulator should confirm that the applicant successfully completed all terms of the sentence and probation. This option also can be used for a producer with a record of prior administrative action.
2. Enter into a supervisory agreement, whereby another established licensed producer agrees to be responsible for the applicant during a certain period of time of the applicant's license term. This is a good option for producers who have criminal records in another state or some other evidence of past bad conduct. The supervisory agreement should include a requirement that the supervising producer report to the insurance regulator any inappropriate behavior that is relevant to the agreement and to the applicant's license status.
3. Issue only a limited or restricted license for a particular product, such as credit life insurance. The theory of this option is that some types of products present individuals with less opportunity to commit bad acts.
4. Issue the license along with a requirement that the producer must report all complaints received against the producer and under the condition that there will be an immediate suspension for any bad act.

Recommended Best Practices for Insurance Regulators

- Work with state officials to adopt a fingerprint program that allows your state criminal justice agency to receive electronic prints, as well as electronically submit the reports back to the state DOI.
- If no fingerprint program is in place, inquire of the state criminal investigation department to determine if an alternative system for meaningful state background checks can be arranged.
- Allow pre-exam and post-exam fingerprinting.
- Make electronic fingerprinting available at test sites.
- Allow re-fingerprinting, if necessary, on a walk-in basis with no additional cost.
- Include registration for fingerprinting with registration for the exam, or link the online websites to allow for electronic registration.
- Streamline the background check process to avoid delay in the overall licensing process such as allowing for a temporary work authority pending receipt of the background check results.
- Check with other state agencies to determine what vendor(s) are used for the submission of electronic fingerprints (agencies that oversee programs such as teachers, bus drivers, social workers, foster parents, etc.)
- Adopt the NAIC's *Authorization for Criminal History Record Check Model Act* (*#222*) for all license classes. (Allow some lag time before the effective date to provide sufficient time to establish procedures.) Note that ULS 14 has since been updated to fingerprint new resident producers and that fingerprints are no longer required for additional lines of authority under an existing home state license.
- The PLMA allows a producer to reinstate a lapsed license within 12 months of expiration, so only resident producers who are reinstating a license lapsed over 12 months should be required to submit fingerprints.
- Work with your state district attorney official to coordinate review and approval of the enabling statute, which must be approved by the U.S. attorney general to access the Criminal Justice Information Services (CJIS) division of the FBI criminal history record information.
- Establish a set number of times an applicant should be re-fingerprinted. (At times, fingerprints are rejected.) If re-fingerprinting is required, and the fingerprints are still rejected, establish a process to perform a state and federal NAME check.
- If your state is unable to use a vendor to electronically collect the cost of the criminal history background check from applicants, work with NIPR to collect this fee from new resident producer applicants during the electronic resident licensing application.
- Work with state officials to establish a reimbursement services agreement (RSA) for the payment of fingerprint or background checks.
- If your jurisdiction is just implementing fingerprinting, reach out to other jurisdictions for suggestions and best practices.
- Develop a system for review of 1033 consent waiver applications and post relevant information on the department website.
- Post all information regarding 1033 consent waiver requests, approvals and denials on the 1033 SDR – Data Entry Tool.
- Accommodate applicants to the greatest extent possible with flexible hours of operation.
- Allow payment by check, credit card or debit card.

Chapter 8

Testing Programs

Introduction

The states have a responsibility to ensure that licensing examinations are fair, sound, valid and secure. Directors must consider how an exam is developed, who is involved in the development process, how the exam is offered and how security is maintained. Nearly every state has contracted with an outside vendor to assist in examination development and administration. These testing vendors employ test development experts and psychometricians to construct and evaluate examinations.

The primary purpose of a state examination and licensing program is to protect consumers. Examinations should be consistent across the states in difficulty level, content and subject matter. They should be uniformly administered and scored. Examinations should be psychometrically sound, using methods for setting and maintaining passing standards (i.e., cut scores) that are in accordance with testing industry best practices. They should use resources such as: 1) the Standards for Educational and Psychological Testing, developed jointly by the American Educational Research Association (AERA), American Psychological Association (APA) and National Council on Measurement in Education (NCME); and 2) the U.S. Equal Employment Opportunity Commission's (EEOC) Uniform Guidelines on Employee Selection Procedures (29 CFR 1607). Through valid, reliable and legally defensible test development practices, candidates will have a fair and equitable opportunity to pass an exam, regardless of which state exam they take. Ideally, pass rates should be consistent throughout the states; however, statistics from national examination administration have shown that the pass rates for examinations for the same line of insurance vary significantly among the states. Other variables may contribute to pass rates, such as state education systems, demographics, the existence of a prelicensing education requirement and the quality of such prelicensing education, but the states should work with their test vendors to be sure that they eliminate any practices that do not measure the entry-level knowledge, duties and responsibilities of an insurance producer.

Different states take different approaches to the development and administration of producer license examinations. Some of the states exercise significant control over test development and review. Other states rely almost entirely on outside experts. In most of the states, the state does not pay any fee to a testing vendor, and the cost of test development and administration is passed through to the test-takers. Most of the states reserve the right to preapprove any fees charged by testing vendors.

With the state licensing system increasingly built on reciprocity, it is in the best interest of consumers, insurance regulators, industry, producers and prospective producers for state licensing directors to establish guidelines that promote efficiency and consistency throughout the licensing process. Directors also should reduce or eliminate artificial barriers that impede qualified applicants from obtaining a license.

The purpose of this chapter is to recommend best practices for states in testing administration in the following areas:

1. Test development and review.
2. Test administration.
3. Test results.
4. Expectations for test vendors.

This chapter was developed with assistance from insurance test vendors, industry representatives, education providers and insurance regulators.

PLMA Guidelines on Examinations

Section 5 of the PLMA contains guidance for administering licensing examinations. Under Section 5, all residents are expected to complete a written examination, which should include the following:

1. The entry-level knowledge required for an individual concerning the lines of authority for which the application is made.
2. The duties and responsibilities of an insurance producer.
3. The applicable insurance laws and regulations of the state.

Section 5 grants the insurance commissioner authority to hire an outside testing service to administer examinations and impose nonrefundable examination fees.

The PLMA contains several exemptions from prelicensing education and examination requirements. An individual who is licensed as a nonresident in a state and who moves into that state, or an individual who moves from his or her home state to another state and seeks a resident license, is not required to complete an examination for the line(s) of authority previously actively held in the prior resident state as long as application is made within 90 days of the change in residence and the prior resident state indicates the producer was licensed in good standing. In this situation, a nonresident state should never impose prelicensing education or examination requirements.

The ULS provide that examinations are not generally required for limited lines, but that it is acceptable to require examinations for areas such as crop and surety.

The PLMA leaves test development and administration to the discretion of the individual states. Section 5(A) of the PLMA requires that "[a] resident individual applying for an insurance producer license shall pass a written examination" and requires that the examination must test the knowledge of the individual in three areas:

1. The specific lines of authority for which the application is made.
2. The entry-level duties and responsibilities of an insurance producer.
3. The applicable insurance laws and regulations of the state.

Beyond these broad subject matter categories, Section 5 states that tests "shall be developed and conducted under rules and regulations prescribed by the insurance commissioner."

In order to provide more uniformity in state licensing practices, the 2012 revised ULS for Exam Content or Subject Area and Testing Administration Standards establishes implementation of the "Exam Content and Testing Administration Recommended Best Practices found in Chapter 8 of the NAIC *State Licensing Handbook*" as the uniform standard.

Test Development and Review

Test development experts believe that licensing examinations should measure the minimum competency required for a candidate to perform at an entry level. Therefore, test content and curriculum development should be focused on assessing whether a candidate demonstrates sufficient knowledge to pass an examination that is appropriately targeted to an entry-level producer.

The examination should not dictate the curriculum that an entry-level insurance producer should master. Instead, the test content should be developed using the steps outlined below. Examinations and curriculums should be updated to reflect any changes in insurance laws, regulations or industry practice. An online candidate guide should be available and should provide detailed testing and licensing procedures, as well as content outlines with cross-references to the curriculum.

Input from trainers who conduct test preparation courses may assist in the development of the curriculum and the exam content outline; however, some insurance regulators believe it is not appropriate to invite these trainers to participate in reviewing final examination questions. Education providers who do not offer prelicensing education courses (such as CE providers) sometimes are used during test development. There are generally two approaches to examination construction. A bank-based test generates individual examinations from a large bank of items. A form-based examination will consist of a specified set of predesigned test forms that are rotated. The states use both methods, and both are psychometrically acceptable. Although contracted outside experts play a major role in test development in most jurisdictions, the state should have a regular process and procedures for developing and reviewing licensing examinations to ensure that those examinations are properly focused on the minimum competencies required of an entry-level producer. Some items that should be included in the plan include:

1. Procedures to ensure that a job analysis survey that includes input from insurance regulators and the industry is conducted at regular intervals to determine the requirements and work performed by an entry-level insurance producer.
2. Regular, ongoing review and assessment of producer licensing examinations in the event of legislative or regulatory changes that could affect the accuracy of exam content.
3. An annual review of the examination development process conducted with the state and the testing vendor.
4. Depending on test volume, test performance and the need for content changes, either an annual (or at least biannual) substantive review of the examination and the psychometric properties of the test. These efforts should include the involvement of content or test development professionals, department personnel and industry representatives, including recent, entry-level producers.

5. A fair and valid state-based test should incorporate knowledge, skills and abilities that measure state-specific and national expertise. This balance will shift depending on the subject matter. For example, life insurance laws and regulations tend to be more similar among the states, while health insurance standards can vary widely.
6. If the state collects demographic data, it should be reviewed annually.

Developing the Questions

Developing a valid and sound bank of test questions, often called "items," is perhaps the most critical piece of any testing program. The items need to be at the appropriate level of difficulty. Items should be relevant to the profession and should be effective in evaluating whether the person taking the exam possesses the knowledge, skills and abilities critical to competently performing the job and safely practicing in the profession. To create this balance, most of the states use a combination of local subject-matter experts (SMEs) and content or test development professionals. The local panel should include new and experienced producers to help establish such a balance.

Using multiple item writers to develop test content is a common practice, but it can lead to variation in test item style, format and difficulty. Developing a style guide with templates, development standards and rules can go a long way in improving item consistency, format and variety. Content development training can ensure that writers have the tools they need to develop credible, legally defensible items and templates that can be leveraged to create multiple variations of the same question.

Passing Score vs. Pass Rate

A passing score, sometimes called a "cut score," is the minimum score one needs to achieve in order to pass the exam. The "pass rate" is the percentage of candidates who actually pass the exam. The test development process will consider data from actual tests and data from reviewers rating the items and exams in evaluating the cut score.

In some of the states, the cut scores are arbitrarily established by rule or regulation. This is not a valid testing practice. Cut scores should be based on data collected through the test-development process. Regulatory licensing exams typically target a level referred to as "minimum" competency rather than "average" competency. Licensing examinations try to determine who has the minimum competency to safely practice in a profession without compromising the health and safety of the public. An arbitrary cut score, which is the practice in some of the states, tends to focus on the average, rather than minimum, competency. Thus, qualified candidates could be cut because they fall below the average, not because their competency is unacceptable.

Exam Scoring

Some of the states administer a one-part or one-score exam, while others administer two-part exams. In the one-part exam, general product knowledge and state-specific content are scored together. In the states with a two-part exam, the candidate must separately pass both the general product knowledge exam and the state-specific exam in order to be eligible to apply for a license for the line of authority requested. A third variation is to require the first-time test-taker to pass an exam on state-specific insurance laws and regulations once. All additional lines of authority are tested on general product knowledge only.

Preliminary review of pass rates indicates a tendency for more candidates to fail in the states that require two-part exams. There is no evidence that two-part exams increase consumer protections or that the states that administer one-part exams license producers who do not know applicable state law. The states are encouraged to move to one-part exams to allow for more success among candidates without jeopardizing consumer protections.

Exam Content

As of May 2013, the states have no standard exam curriculum. The NAIC is encouraging more uniform approaches by considering the best practices for testing programs listed at the end of this chapter to be standards for all jurisdictions to work toward. The Producer Licensing (EX) Task Force formed a subgroup of five states to develop a draft national content outline using the life and annuity line of authority as a pilot. The national content outline provides guidance for entry-level subject matter that the states should test for, as well as information that will assist candidates in identifying relevant knowledge to study in preparation for the exam.

Some experts have recommended that examinations should be constructed with the following considerations in mind:

1. The states should not target examinations to an artificially set passing score. A state should determine whether its test is focused on assessing the knowledge needed by potential new producers, and only applicants who lack that

level of knowledge should fail. The states should use legally defensible, recognized methodology when establishing a cut score.

2. Prior to releasing items into an exam form, the editing and review process employed is critical. This editing process should include the psychometric evaluation of the cognitive level of the items and the reading level of the items, as well as such editorial issues as grammar, sensitivity and style. Psychometric editing is best performed by test development professionals, not state SMEs or item writers. Individuals trained in the complexity of psychometric editing evaluate items in a different, critical light than SMEs or item writers. It is critical, however, to have all final items reviewed and approved by state and national SMEs in the given field for accuracy and relevancy.

3. Each examination should consist of pre-test questions that are being evaluated for performance and questions that previously have been evaluated (pre-tested) and determined to be statistically effective. Each candidate's score should be based only on the previously pre-tested and approved questions. Any time used to respond to pre-test items should not be counted against the test-takers, and responses to pre-test items should not be calculated in the test-taker's score. Pre-test items should not be used as scored items until they have been statistically proven to be effective. The test questions for any new examination should be chosen from the pool of test questions to properly represent the subject-matter outline of the examination.

4. Reports regarding exam pass rates, candidate demographics when collected and number of exams administered should be made available to the public. Reports should include first-time pass success by subject area. Whenever possible, this information should be tracked by, and be made available to, each education provider so they may evaluate their programs and instructors, and be provided with data needed for course development. The states may ask for, but generally cannot require, information on candidate population, gender, ethnicity, education level and income level. When candidate demographics are collected, reports should include the percentage and number of examinees who passed the examination by race, ethnicity, gender, education level and native language. This information is necessary for the selection of future test questions, and will aid in making testing transparent and assessing whether differences in test scores are correlated with relevant demographic factors.

5. A state advisory committee consisting of insurance regulators and the industry—including, where possible, recently licensed producers—should annually (or, if changes are not needed every year, at least biannually) work with the testing vendor to review the questions on each examination form or bank of items for substantive and psychometric requirements. Adjustments should be made to the examination to eliminate any questions that might be inaccurate or unclear, that might test subject matter that is beyond what a new producer should know or that exhibit unsatisfactory psychometric properties.

6. Licensing examinations should be reviewed at least annually, but if, during any rolling 12-month period, a licensing examination exhibits uncharacteristically high or low pass rates (such as less than 60% or more than 80%), unexplained fluctuations in testing volume or other significant deviations, that examination should be reviewed immediately.

A state testing program should include statistical analysis of test items in the field and gather feedback on the candidate performance on the individual items. The most obvious and critical use of this information is to ensure that exams are equivalent, and to evaluate the accuracy with which items differentiate between candidates who are minimally qualified and candidates who are not. The psychometric review can result in the continued use of items, the modification of items or the deletion of items from the bank.

A professional test vendor should use a comprehensive strategy for developing test items and ensuring measurement of the knowledge, skills and abilities necessary for initial insurance licensees to perform their jobs effectively. The steps may include:

1. Conducting a committee-based job analysis.
2. Developing content specifications and weightings.
3. Developing items.
4. Editing and reviewing items with SMEs to ensure items meet the required criteria.
5. Obtaining item difficulty (e.g., Angoff method) estimates to establish a passing score.
6. Developing item sampling groups to structure each examination.
7. Creating equivalent forms.

Test Development Deliverables

A state licensing director should expect to receive the following items to ensure that the testing vendor has provided all items necessary to administer a successful testing program:

1. Finalized task and knowledge statements reflecting the requirements of each licensed insurance position.
2. Content specifications for each licensing examination.
3. A set of approved, relevant and important items for use on each licensing examination.
4. A list of references used to develop the test items.
5. Candidate Information Bulletins (CIBs).
6. A technical report describing the procedures used and results obtained from the test development process for each licensing examination.

Candidate Information Bulletin

A CIB should describe the examinations, examination policies and procedures, and the consequences of violating security procedures. A testing vendor should be capable of making changes to the information contained within the CIB during any contract year at the state's request.

The CIB should be available at no charge to candidates, trainers and insurers in hard copy or in electronic format via the Internet. The state licensing director should consider including the following topics in the CIB:

1. How to contact the testing vendor.
2. Requirements for taking an examination.
3. How to apply for an examination, including receiving authorization of eligibility from the state, prelicensing education and background checks.
4. Links to current application forms.
5. How to obtain current forms in hard copy (if available in hard copy).
6. Examination fees.
7. Scheduling procedures.
8. The content outline and format of the examination.
9. Supplies provided at the test center.
10. The time limit for the examination.
11. The scoring system.
12. Security procedures.
13. Examination process and procedures.
14. Appropriate examination-taking strategies (e.g., "There is no penalty for incorrect answers, so be sure to answer every question.").
15. Appropriate use of scratch paper, calculators and/or other support material.
16. Sample questions.
17. Specific information about taking the test on the computer.
18. List of approved reference materials.
19. List of test centers, alternative test centers and driving directions to each.
20. Procedures for requesting special accommodation.
21. Examination registration forms.
22. Licensing requirements and procedures.
23. Refund policies.
24. Holiday or weather-related test center closures.
25. Instructions about how to contact the state insurance department.

A state should approve each CIB before it is published. The licensing director should work with the vendor to set a timeline that will allow for final publication of an updated CIB in advance of the expiration of the prior edition of the CIB. The new edition should be provided to test preparation trainers at least six weeks in advance of implementation so that training materials can be updated.

Technology Issues

A licensing director should consult with the state's information technology (IT) staff to ensure that the testing vendor can deliver data to the state insurance department. This is critical when a state changes testing vendors. This also is critical if the state directs a vendor to send data to a different location than the state insurance department. Any transition should include a testing phase for hardware, software and state insurance department staff.

The state and the testing vendor should jointly agree on a timeline for introducing new or updated examinations. State IT staff also should be consulted.

Legal Defensibility

Items developed also must be legally defensible to protect the state in the event of a legal challenge. To protect the state from liability, each exam should be critically reviewed from a content and psychometric perspective to ensure that the exam was developed according to recognized standards. Validation procedures for licensing examinations should be designed to comply with content validation requirements of the EEOC's Uniform Guidelines on Employee Selection Procedures (29 CFR 1607).

The states should require testing vendors to follow and document standardized methods. This should include appropriate test development personnel in the process. Using the appropriate, credentialed professionals is critical, as there are multiple steps involved in the test development process and various methodologies that can be used for each step. State licensing directors should discuss all options with qualified professionals.

Vendor Responsibilities

Test vendors should be able to meet minimum guidelines for sufficient availability, facilities, personnel and openness in terms of providing information related to their operations.

The states, and not the test vendors, must be responsible for all examination content and content outlines. The vendor should provide accessible information regarding the registration system through the Internet, toll-free telephone numbers, interactive voice response, fax and other available technologies. The available information should include permitting candidates to view exam test dates and to access forms and content guidelines without requiring prior payment and scheduling of an exam.

The vendor should promptly provide the state with all pertinent information, including prompt notification of any candidate complaints, changes to test administration, conflicts at examination test sites or other information requested or required by the state.

The vendor should provide quality, accessible facilities, with an established system of examination site supervision that ensures that competent site administrators consistently provide accurate information to applicants.

Where a vendor operates test sites in multiple states, the vendor should permit any applicant to take a state's examination in another state, under the same conditions that would apply if the exam were taken at an in-state location.

Vendors should be required, on an ongoing basis, to collect the data on customer satisfaction and, if directed by the state, to make those data available to insurance regulators, the industry and the public.

Test Administration

The testing process should be fair and accessible for all candidates. A state should consider including the following elements below in its licensing process to ensure applicants have equal access to examinations.

Secure Administration

The security of the test center network is important in maintaining the integrity of a test. A vendor should be equipped with adequate security features and qualified test center administrators. Each proctor should be trained and tested on his or her ability to supervise exams. A vendor should have systems in place to ensure the fair, consistent and even administration of the exam in every location. A vendor also should have a method to detect attempts to record questions. For example, a vendor should track multiple examination attempts by individuals to assess if the candidate is intentionally failing the exam so it can be repeated. A vendor should be required to notify the state immediately if the vendor suspects that the integrity of an examination has been compromised.

Test Locations and Registration

Test locations should be set up to provide flexibility and convenience. Realizing that the states have different geographic challenges and diverse population density, a state should consider, where possible, requiring the following elements:

1. Testing should be made available at locations convenient to residents of all areas of the state.
2. Test locations should provide enough testing capacity so a candidate can test at the desired location within two to five business days of registration.
3. Exam site hours should include evening and weekend hours.
4. Test vendors should provide regular reports as required by the state detailing site usage and availability data.
5. Test registration should be available online or by telephone and allow for next day testing when space is available. A state should consider tracking telephone hold and wait times to monitor how long callers wait.
6. State guidelines should provide for flexible means for payment of fees for testing, fingerprinting and other licensing. The states should consider methods which facilitate payment by companies.

Disabilities

A state should require a vendor to develop a system that accommodates the physically impaired that is not related to a testing candidate's knowledge of insurance. Visually impaired and hearing-impaired persons should be accommodated through all steps of the licensing process, pursuant to national standards set by the federal Americans with Disabilities Act (ADA).

Examinations in Languages Other Than English

Some industry experts suggest caution about using translated or interpreted exams. The material may not directly translate into equivalent terms or meaning. Cultural biases might cause incorrect interpretation of a meaning. Some experts recommend that tests should be developed and administered in English, especially if other materials necessary to perform job duties for the profession (such as contracts) are in English. State licensing directors should review state law and consult with legal counsel about the appropriateness of offering examinations in a foreign language.

Reporting Examination Results

State licensing procedures should include guidelines that facilitate the prompt issuance of licenses once an applicant passes a test. Elements might include:

1. Pass/fail notices should be issued at exam sites upon completion of the exam. If an applicant has not achieved a passing score, the applicant should receive immediate notification of failure. The states vary as to whether successful completion is reported with a precise score or merely an indication that the candidate passed the exam. When a candidate does not pass the exam, the state should provide the precise score and the percentage of questions in each subject area that the applicant answered incorrectly.

2. If a state issues a paper license, and if it has been predetermined that an applicant has met all requirements necessary for licensure, including any required fingerprint report, a license should be issued at the exam site, or within 48 hours of completing all necessary requirements.

3. The state should send an email or other timely communication to a candidate to whom a license has been issued outside the test site or provide information to applicants as to how to check online.

4. Within 24 hours of license issuance, the new licensee's information should be added to the state's database, and the updated status should be sent to NIPR.

5. The states should work with their vendors to report aggregate results in a way that is more uniform with other states.

6. First-time pass rates should be maintained and made available to the public. First-time pass rates are defined as the percentage of candidates who pass the whole test the first time.

7. In performing background checks, the use of an electronic process should be required whenever possible.

8. In those states requiring fingerprints, where possible, exam sites should have the capability to collect electronic fingerprints.

Retesting or Notice of Failure

A state licensing plan should include a method to facilitate prompt retesting of applicants who have failed a test. The "non-passing" notice should break scores out by each subject area. If the candidate requests to make another attempt, an examination should be made available within a reasonable time period.

Producer Exam Content and Testing Administration Recommended Best Practices for Insurance Regulators

- The states should use accepted psychometric methods including job analysis to determine if the examination content falls within the content domain that a minimally competent candidate of that specific line of authority tested would be expected to know.
- The states should set passing scores (cut scores) and difficulty level using psychometric methods and appropriate SMEs based on what an entry-level producer needs to know.
- The states are encouraged to move to one-part exams to allow for more success among candidates without jeopardizing consumer protections.
- The states should require the test vendor (or other entity responsible for test development) to document the process for ensuring quality control and validity of the examination, including psychometric review and editing and analysis of item bias or cultural and gender sensitivity.
- To allow for meaningful comparison, all jurisdictions should define first-time pass rate as the percentage of candidates who pass the whole test the first time.
- At least annually, reports regarding exam pass rates, candidate demographics when collected and number of exams administered should be made available to the public. Reports should include first-time pass success and average scoring by subject area. Whenever possible, the reports should be available by education provider and provided to them.
- A state advisory committee consisting of insurance regulators and the industry—including, where possible, recently licensed producers—should annually work with the testing vendor to review the questions on each examination form for substantive and psychometric requirements. If, during any other time, any examination results exhibit significant unexplained deviations, the examination should be reviewed.
- The states should work with testing vendors and approve CIBs that describe the examinations and examination policies and procedures, and provide sufficient examination content outline and study references for the candidate to prepare for the examination. Updated editions of the CIB/content outline should be provided to prelicensing education providers at least six (6) weeks in advance of implementation so that training materials can be updated.
- Testing should be made available at locations reasonably convenient to residents of all areas of the state, with registration available online or by telephone and the ability for a candidate to schedule testing within two to five business days of registration.
- Pass/fail notices should be issued at exam sites upon completion of the exam. The fail notice should break out scores by subject area. The state should provide a method to facilitate prompt retesting, while allowing a reasonable time for candidates to review and prepare for retest.
- The states should deliver exams in a secure test center network that employs qualified test proctors.
- The states should set clear performance standards for test vendors and require accountability.

Chapter 9

Lines of Insurance

The Major Lines

A line of authority is a general subject area of insurance that a producer can be licensed to sell. The PLMA identifies and defines seven lines of authority; however, the ULS set forth six lines that are considered major lines of authority, as well as certain core limited lines. Additionally, the ULS set forth standards for non-core limited lines. The states should review all other lines of insurance and consider eliminating them in an effort to become compliant with the ULS.[1] Uniform adoption of the major lines is essential to fully implement NAIC licensing reforms.

The six major lines of authority are defined in the PLMA as follows:

1. Life – insurance coverage on human lives including benefits of endowment and annuities, and may include benefits in the event of death or dismemberment by accident and benefits for disability income.
2. Accident and health or sickness – insurance coverage for sickness, bodily injury or accidental death and may include benefits for disability income.
3. Property – insurance coverage for the direct or consequential loss or damage to property of every kind.
4. Casualty – insurance coverage against legal liability, including that for death, injury or disability, or damage to real or personal property.
5. Variable life and variable annuity – insurance coverage provided under variable life insurance contracts and variable annuities.
6. Personal lines – P/C insurance coverage sold to individuals and families for primarily noncommercial purposes.

Because the ULS also require that each major line be available individually, the states should provide individual examinations for each of the major lines except variable life and variable annuity. It is acceptable for a state also to offer combined exams. The ULS contemplate that each state will require an examination for residents to qualify for all major lines. The states should give examinations only to residents, not nonresidents.

While the ULS do not specifically prohibit an examination for variable life and variable annuity products, most states do not require an examination. This line of authority is usually granted if the applicant holds a life line of authority and has successfully completed the Financial Industry Regulatory Authority (FINRA), formerly known as the National Association of Securities Dealers (NASD), examinations necessary to obtain a state securities license in that state. In most cases, this means successful completion of the FINRA Series 6 and/or Series 7 (according to the specific state's requirements) and/or Series 63 exams.

The Producer Licensing (EX) Working Group has not specifically stated that states should not require an active state securities license of residents or nonresidents as a condition of granting the variable life and variable annuity products line of authority. The ULS do contemplate that no such requirement shall be imposed. For nonresident applicants, it is not appropriate to pend a request for the variable life/annuity products line of authority to verify existence of the underlying life line of authority in the home state. If a proper request for licensure is received and the applicant is in good standing in the home state with the variable life and variable annuity line of authority, the nonresident license should be granted. If a state cannot verify through the SPLD that the applicant holds a variable authority, it is permissible to pend the application and contact the applicant's home state to verify the variable authority.

Information regarding an applicant's status as to securities registration and securities examinations passed currently are easily accessible on FINRA's public Web site (under "Check Out Brokers & Advisors" at *www.finra.org/InvestorInformation/index.htm*). Information available includes: employment history; states where the individual is securities licensed; securities examinations passed; and formal and final disciplinary history. To obtain Central Registry Depository (CRD) information regarding pending complaints and unresolved cases, a state insurance department must contact its state's securities regulator.

[1] The PLMA does not address title insurance, which is considered a major line by some of the states and a limited line by others.

Recommended Best Practices for Regulators
• Adopt the major lines and the definitions exactly as stated in the PLMA and provide separate testing for each line, except variable • Allow combined examinations, as appropriate

Limited Lines

A limited line of insurance is a line of insurance that covers only a specific subject matter. Limited line licenses generally have simpler licensing requirements than required by the major lines. Some states require an examination for credit insurance. For the other limited lines, some states require an examination, while some require only a simplified application process. In some states, a business entity is permitted to maintain a limited lines license on behalf of individuals who make the limited line of insurance available to its customers. Often, a limited line is adopted by regulation and not by statute.

The PLMA contains a specific definition for credit insurance and allows states to define other limited lines. The Producer Licensing (EX) Working Group adopted definitions for specific "core" limited lines of insurance for producers, which have become part of the ULS. States are encouraged to adopt the definitions of those limited lines and to review and eliminate as many non-uniform limited lines as possible. The PLMA requires states to grant to a nonresident a nonresident limited line producer license with the same limited line of authority as the license issued by the home state. Many states have adopted a special licensing category to accommodate this type of situation.

The core limited lines are:

1. Car rental insurance.
2. Credit insurance.
3. Crop insurance.
4. Travel insurance.

The ULS provide that examinations are not generally required for limited lines, but that it is acceptable for examinations for areas such as crop and surety. The states should give examinations only to residents, not nonresidents. The ULS specifically state that CE is required for only the major lines of insurance. (See specifics for crop insurance.)

In 2009, the Producer Licensing (EX) Working Group was charged with reviewing limited line licensing issues, with particular focus on: 1) the establishment of a limited lines that encompasses several insurance products where the business of insurance is ancillary to the business of the person offering the product; 2) the licensing requirements of individuals selling limited line products; and 3) the fingerprinting of individuals selling limited line insurance products. Throughout the year, the Producer Licensing (EX) Working Group had discussions; however, no consensus was achieved. As a result, the Producer Licensing (EX) Working Group reported to the Producer Licensing (EX) Task Force and requested further guidance on its charge. For 2010, the Producer Licensing (EX) Working Group was asked to:

Finalize the review of limited-line licensing issues, with particular focus on the following: 1) individually review the licensing requirements for each core limited line; 2) review other limited lines, and determine what licensing requirements should apply to them; and 3) determine if another "catch all" limited line was needed to address licensing requirements for insurance products not already encompassed within the list of limited lines. Updates to the limited line charge may be obtained on the Producer Licensing (EX) Working Group's web page on the NAIC website.

The NAIC has adopted a specific resolution rejecting a prior request by industry to adopt a new limited line for term life insurance. The full text of the resolution is in the Appendices.

As part of its 2010 charges, the Producer Licensing (EX) Working Group conducted a review of the ULS and adopted several amendments. Specifically related to this chapter, revisions were made to Standard 16 (Lines of Authority), Standard 33 (Definition of Core Limited Lines), Standard 34 (Travel) and Standard 37 (Non-Core Limited Lines).

Recommended Best Practices for Regulators

- Allow resident and nonresident limited lines license applications to be filed electronically.
- Eliminate state-specific applications.
- To further reciprocity, report all limited lines licensees to the SPLD.
- Adopt the applicable revisions to the ULS related to limited lines.

A. Limited Line of Car Rental Insurance

Under the ULS, car rental insurance is defined as:

> [I]nsurance offered, sold or solicited in connection with and incidental to the rental of rental cars for a period of [per state law], whether at the rental office or by pre-selection of coverage in master, corporate, group or individual agreements that (i) is non-transferable; (ii) applies only to the rental car that is the subject of the rental agreement; and (iii) is limited to the following kinds of insurance:
>
> (a) personal accident insurance for renters and other rental car occupants, for accidental death or dismemberment, and for medical expenses resulting from an accident that occurs with the rental car during the rental period;
>
> (b) liability insurance that provides protection to the renters and other authorized drivers of a rental car for liability arising from the operation or use of the rental car during the rental period;
>
> (c) personal effects insurance that provides coverage to renters and other vehicle occupants for loss of, or damage to, personal effects in the rental car during the rental period;
>
> (d) roadside assistance and emergency sickness protection insurance; or
>
> (e) any other coverage designated by the insurance commissioner.

The states vary in their methods of supervising the sale of car rental insurance. In the states that require a license, there are generally three methods in use. The first is a registration requirement through submission of an application. The second is the successful completion of an exam and submission of an application. The states should give examinations only to residents, not nonresidents. Under the third method, a car rental company registers with the state insurance department. The company holds the license and is responsible for supervising the training and testing of its counter agents. The company reports to the department and pays all fees.

B. Limited Line of Credit Insurance

The PLMA defines limited lines credit insurance as:

> Credit life, credit disability, credit property, credit unemployment, involuntary unemployment, mortgage life, mortgage guaranty, mortgage disability, guaranteed automobile protection insurance or any other form of insurance offered in connection with an extension of credit that is limited to partially or wholly extinguishing that credit obligation and that is designated by the insurance commissioner as limited line credit insurance.

Credit insurance products are designed to protect the borrower against the risk of not being able to pay a debt. Credit life, disability and involuntary unemployment insurance are typical lines of coverage. These products are generally made available by the creditor at the time the loan transaction occurs. Because the insurance is purchased at the time the borrower completes the loan, policy and certificate forms, premium structures and underwriting conditions are generally simpler than other limited lines of insurance.

Credit insurance is issued under individual and group policies. This allows market flexibility for different distribution systems and variations in product design to insure the different types of credit risks. If an individual enrolls customers under a group insurance policy, the individual must obtain a limited lines license, if a commission is paid. Section 4(B)(2) of the PLMA provides an exception from licensing if no commission is paid to the enroller and the enroller does not engage in selling, soliciting or negotiating.

Section 6(D) of the PLMA provides that each insurer that sells, solicits or negotiates any form of limited line credit insurance shall provide its producers a program of instruction that may be approved by the insurance commissioner.

Recommended Best Practices for Insurance Regulators

- A state should establish a method to verify that each credit insurer has established a program of instruction.

C. Limited Line of Crop Insurance

Under the ULS, crop insurance is defined as:

> Insurance providing protection against damage to crops from unfavorable weather conditions, fire or lightning, flood, hail, insect infestation, disease, or other yield-reducing conditions or perils provided by the private insurance market, or that is subsidized by the Federal Crop Insurance Corporation (FCIC), including multi-peril crop insurance.

There are two types of crop insurance: multiple peril crop insurance (MPCI) and crop hail insurance.

The federal government is involved with crop insurance because a single event (such as drought) often results in multiple losses. Automobile accidents or health problems generally are independent, random events that do not trigger multiple insurance losses. For crop insurance, multiple losses are the norm rather than the exception. For many years, capital requirements to maintain adequate reserves to cover widespread losses were so high that commercial development of MPCI policies by companies was unrealistic. As a result, the federal government created a federally subsidized risk management program.

Multiple Peril Crop Insurance

An MPCI policy provides protection against crop losses from nearly all natural disasters, including: adverse weather conditions; fire; insects, but not damage due to insufficient or improper application of pest control measures; plant disease, but not damage due to insufficient or improper application of disease control measures; wildlife; earthquake; volcanic eruption; or failure of the irrigation water supply if due to an unavoidable cause of loss occurring within the insurance period.

MPCI is subsidized by the federal government and delivered by private insurance companies. The insurer's functions include hiring and training producers; paying for marketing and advertising; hiring and training loss adjusters; and carrying out loss adjustment activity, billing and collecting premiums, processing and verifying applications, conducting actual production history reviews, processing and verifying acreage reports, paying claims, auditing and verifying claims data, paying uncollected premiums, and maintaining the necessary automated data processing infrastructure to communicate data with the Risk Management Agency (RMA) on a routine basis for all MPCI policies.

The MPCI policy is a contract between the producer and the insurance company and not with the federal government. However, a farmer cannot receive the federal subsidy attached to the program unless the insurance policy followed the federal standards and rates. Like many insurance companies, crop insurance companies have reinsurance agreements to transfer risk to other private companies known as reinsurers. Unlike most other insurance lines, the private insurance companies also transfer some of the risk associated with the crop insurance program directly to the federal government.

There are many MPCI plan options available: yield-based, revenue-based or a combination of both. The basic policy provisions for all these plans, as well as the rates, are set by the FCIC. A combination of commodity markets results and the U.S. Department of Agriculture (USDA) establish the maximum price for each crop each year for insurance purposes (i.e., the value of each bushel in the event of loss).

While the RMA controls pricing and policy forms, producer licensing and enforcement of proper sales practices are left to the states.

Crop/Hail Insurance

Crop/hail insurance is offered through companies licensed by state insurance departments. A private market has existed for crop/hail insurance for more than a century. Companies have developed stand-alone full coverage and deductible crop hail policies, as well as companion policies that function very well in conjunction with the different MPCI plans that are offered at varying coverage levels. The premium rates for these crop/hail policies are determined by historical loss experience and are set by the companies.

Continuing Education

Subsequent to the adoption of the ULS, the Producer Licensing (EX) Working Group considered and agreed that a CE requirement for crop insurance shall not be a violation of the uniform standards. Under federal law, insurance producers selling MPCI are required to attend CE classes each year.

D. Limited Line of Surety

As part of the discussion of limited lines, the Producer Licensing (EX) Working Group made the determination to remove surety as a limited line. Although this determination was made, it is understood that surety is considered a major line by some of the states and a limited line by others.

E. Limited Line of Travel Insurance

Under the ULS (as revised Aug. 6, 2010), travel insurance is defined as:

Insurance coverage for personal risks incidental to planned travel, including, but not limited to~~,~~:

1. Interruption or cancellation of trip or event.
2. Loss of baggage or personal effects.
3. Damages to accommodations or rental vehicles.
4. Sickness, accident, disability or death occurring during travel.

Travel insurance does not include major medical plans, which provide comprehensive medical protection for travelers with trips lasting six months or longer, including, for example, those working overseas as an ex-patriot or military personnel being deployed.

Standard 34 recognizes and sets the guidelines for the creation of an additional business entity licensing model under the travel limited line licensing structure. This structure creates the concept of a “travel retailer” in which the entity and a certain number of its employees may disseminate travel insurance under the direction of a responsible licensed producer. Said producer maintains responsibility for the training and conduct of any and all associated travel retailer(s).

Recommended Best Practices for Regulators

- A state adding the travel limited line should do so in accordance with applicable ULS.

F. Non-Core Limited Lines

After much discussion about the concept of “auxiliary” or “miscellaneous” lines, the Producer Licensing (EX) Working Group formally adopted Standard 37 as a basis for any future addition of other non-core limited line. The standard states, in part, that:

A state is not required to implement any non-core limited line of authority for which a state does not already require a license or which is already encompassed within a major line of authority; however, the states should consider products where the nature of the insurance offered is incidental to the product being sold to be limited line insurance products. If a state offers non-core limited lines (such as pet insurance or legal expense insurance), it shall do so in accordance with the following licensing requirements. Individuals who sell, solicit or negotiate insurance, or who receive commission or compensation that is dependent on the placement of the insurance product, must obtain a limited line insurance producer license. The individual applicant must: 1) obtain the limited lines insurance producer license by submitting the appropriate application form and paying all applicable fees as set forth in applicable state law; and 2) receive a program of instruction or training subject to review by the insurance department

No prelicensing or testing shall be required for the identified non-core limited lines insurance.

Chapter 10

Surplus Lines Producer Licenses

In order to operate in a state, P/C insurance companies are generally categorized in one of two ways. An admitted company obtains a certificate of authority to operate in a given state and is fully subject to and regulated by the laws of the state. Its policyholders are protected, at least to some extent, by the state's guaranty fund.

A nonadmitted company, otherwise known as a surplus lines company, has limited authority to operate in a state. These companies may be required to be eligible in a state but are subject to significantly less regulation. States allow surplus lines companies to operate because they recognize that certain types of insurance, or insurance at certain amounts, are not available from admitted companies. Generally, surplus lines companies are not subject to rate and policy form regulation, and their policyholders are not covered by state guaranty funds.

Under the ULS, a producer who wishes to engage in the sale of surplus lines insurance (SLI) must first obtain a surplus lines producer license. Under the ULS, this is considered a license type and not a line of authority; however, in some of the states, it is treated as a line of authority. The ULS require that a resident producer hold both property and casualty **(P/C) or accident and health or sickness (A/H) [Pending Producer Licensing Task Force' adoption of the amendments on August 3rd]** lines of authority before an SLI producer license can be issued. Under the previous reciprocity provisions of the GLBA, surplus lines producers were entitled to reciprocal licensing if they were licensed for surplus lines and in good standing in the producer's home state. The NAIC uniform application is to be used for application as a surplus lines producer.

Some of the states also require a resident producer placing SLI to complete an examination or post a bond. However, to comply with the reciprocity provisions of Section 8 of the PLMA, these requirements cannot be imposed on nonresidents. States cannot impose an additional CE requirement on nonresident SLI producers.

The Nonadmitted and Reinsurance Reform Act

The federal Nonadmitted and Reinsurance Reform Act (NRRA) was signed into law by President Barack Obama on July 21, 2010, as part of the federal Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5301. The NRRA set federal standards for the collection of surplus lines premium taxes, insurer eligibility, producer licensing and commercial purchaser exemptions. Most of the provisions of the NRRA went into effect on July 21, 2011.

For licensing of surplus lines brokers, the most significant change was to limit the licensing requirements to only the home state of the insured. Specifically, to place a surplus lines multistate risk policy, the broker needs only to be licensed as a surplus line broker in the insured's home state, not in all of the states where the policy risk is located. The NRRA defines the home state of the insured as "(i) the state in which an insured maintains its principal place of business or, in the case of an individual, the individual's principal residence; or (ii) if 100% of the premium of the insured risk is located out of the state referred to in clause (i), the state to which the greatest percentage of the insured's taxable premium for that insurance contract is located." The definition goes on to clarify that, with respect to affiliated groups, "[i]f more than one insured from an affiliated group are named insureds on a single non-admitted insurance contract, the term 'home state' means the home state, as determined pursuant to [clauses (i) and (ii) above], of the member of the affiliated group that has the largest percentage of premium attributed to it under such insurance contract."

The NRRA also prohibits a state from collecting fees relating to the licensing of a surplus lines broker unless the state participates in the NAIC's national insurance producer database for surplus lines broker licensure by July 21, 2012. Currently, all states accept applications and renewals for surplus lines broker licenses for individuals through the NIPR and all but one state accept applications and renewals for surplus lines broker licenses for business entities.

Surplus Lines Distribution Systems

Surplus lines insurance is generally produced through one of two distribution systems. One, generally referred to as a retail distribution system, involves a single broker accessing the surplus lines company directly to place insurance. The second, generally referred to as a wholesale distribution system, involves a surplus lines broker that operates as an intermediary between a "retail agent" and a surplus lines company. In the retail distribution system, there is only one producer in a transaction, so that producer would need to conduct the diligent search of the admitted markets prior to accessing the surplus lines markets (unless there is some exception such as a large commercial purchaser or an export list). In the wholesale distribution system, the diligent search is often conducted by the retail broker, who determines there is no admitted market prior to contacting the surplus lines wholesale broker; however, some of the states have different requirements.

The vast majority of the states take the position that a broker conducting a diligent search would need a P/C **or A/H [Pending Producer Licensing Task Force' adoption of the amendments on August 3rd]** agent's license because it is necessary to solicit insurance, take an application and make a submission to an admitted company. Many states do not require a retail producer to obtain a surplus lines broker's license unless the broker is going to access the surplus lines companies directly. There are a couple of states that require a retailer to have a surplus lines license before using the services of a surplus lines wholesale broker.

Diligent Search Requirements

The vast majority of the states require a "diligent search" of the admitted market to determine if there is an admitted carrier willing to write the risk, prior to accessing the surplus lines markets. A couple of states have abolished the diligent search requirement. Many of the states require that brokers search those admitted companies that are actually writing the coverages sought. If there is no admitted carrier willing to write the risk, the risk can be placed in the surplus lines markets. Many of the states require an affidavit to be completed documenting that the diligent effort was completed. Recently, a number of the states have replaced the affidavit, which was sworn under penalty of perjury, with a report from the surplus lines licensee that the diligent search was conducted. Some of the states also have replaced the requirement that the affidavit (or report) be filed with the insurance department or Surplus Line Association (SLA) with a requirement that the report of the diligent search be maintained in the office of the broker and available for audit by the insurance department.

Many of the states specify that the diligent search can be conducted by the retail broker (commonly called producing broker), when a surplus lines wholesaler accesses the surplus lines markets. The retail broker has access to admitted markets. The retailer uses the services of a surplus lines wholesale broker only after the retail broker has determined that the admitted markets are not willing to underwrite the risk.

The most common diligent search standard requires declinations from three admitted carriers, but as many as five are required. Other states simply require the producing broker to make an effort, a reasonable effort or a good faith effort to place the coverage in the admitted markets. A couple of states require that the insurance not be procurable after a diligent effort has been made to place the coverage among a majority of insurers, but this standard has been called into question as unclear and impractical. A number of exceptions to the diligent search requirement exists in state law, and the NRRA implemented a national exception to the diligent search rules for insureds that qualify as exempt commercial purchasers. Twenty-two states have laws authorizing an "export list" of coverages that the insurance commissioner has determined are not generally available in the admitted markets. Coverages on the export list can be placed in the surplus lines market without a diligent search. In some of the states, the state insurance department is required to conduct an annual public hearing regarding the export list. The purpose of the hearing is to take testimony on the export list to determine whether any items should be added or removed.

The former NARAB (EX) Working Group updated the NAIC's standard for determining compliance with the GLBA's previous reciprocity provisions. In a report that was adopted by the NAIC in September 2009, the Working Group refined its approach to reciprocity relating to any underlying P/C licensing requirements for nonresident surplus lines producers. The Working Group determined that if a state requires the surplus lines producer to perform the diligent search of the admitted market, then the state may require the nonresident surplus lines producer to obtain an underlying nonresident P/C license in addition to a nonresident surplus lines license. However, the Working Group determined that a state may not require a nonresident surplus lines producer also to obtain a nonresident P/C **or A/H [Pending Producer Licensing Task Force' adoption of the amendments on August 3rd]** license if they do not perform the diligent search. Many surplus lines producers do not perform diligent searches because the retailer has already conducted the diligent search, and the law does not require a second diligent search. In such instances, the surplus lines producer is not accessing the admitted market. Consequently, the Working Group determined that it was inconsistent with the previous GLBA reciprocity requirements to require an underlying P/C **or A/H [Pending Producer Licensing Task Force' adoption of the amendments on August 3rd]** license for a surplus lines wholesale broker unless they are required by law to conduct a diligent search or conduct diligent searches in their agency.

The NRRA established a single "exempt commercial purchaser" exemption from state diligent search requirements that is applicable in every state. As of July 21, 2011, a diligent search in the admitted market is not required to place a policy for an exempt commercial purchaser if: 1) the broker has disclosed to the exempt commercial purchaser that coverage may be available from the admitted market, which may provide greater protection with more regulatory oversight; and 2) the exempt commercial purchaser has requested in writing that the broker procure/place such coverage with a surplus lines insurer.

An "exempt commercial purchaser" is defined in the NRRA as a purchaser of commercial insurance that:

> 1) employs or retains a qualified risk manager to negotiate insurance coverage; 2) has paid aggregate nationwide commercial P/C insurance premiums in excess of $100,000 in the immediately preceding 12 months; and 3) meets at least one of the following criteria: (i) possesses a net worth in excess of $20 million (as adjusted for inflation); (ii) generates annual revenues in excess of $50 million (as adjusted for inflation); (iii) employs more than 500 full-time employees per individual insured or is a member of an affiliated group employing more than 1,000 employees in the aggregate; (iv) is a not-for-profit organization or public entity generating annual budgeted expenditures of at least $30 million (as adjusted for inflation); or (v) is a municipality with a population of more than 50,000.

A number of the states elected to maintain their statutory exemptions from diligent search requirements, which were sometimes known as industrial insured exemptions. If the state's industrial insured exemption was more liberal than the NRRA exempt commercial purchaser (ECP) exemption, then the state's requirements were not in conflict with the NRRA, and the exemption in the NRRA would not apply.

SLI producers are routinely subject to additional state administrative requirements that are considered to be outside the scope of licensing reciprocity considerations or the ULS. The regulations regarding the administration of surplus lines are different from other types of insurance because the states typically require the licensed surplus lines producers to perform certain compliance activities that would usually be the responsibility of the licensed insurance company in a transaction in the admitted market. In a surplus lines transaction, the compliance obligations are imposed upon the producer because the producer is the licensed party. The surplus lines insurer is unlicensed and often referred to as a "nonadmitted insurer" in some of the states or "unauthorized insurers" in other states.

There are additional administrative requirements in some of the states for licensed surplus lines producers that apply once the coverage is placed. These may include:

1. Filing reports with state insurance departments or state stamping offices of placements made.
2. Collecting and paying surplus lines premium taxes.
3. Maintaining a record of all surplus lines placements made.
4. Providing the insured with a disclosure stating that the policy he or she has purchased is being issued by an insurer that is not licensed in the state, is not subject to the financial solvency regulation and enforcement that apply to the state's licensed insurers, and does not participate in any of the insurance guarantee funds created by the state's law.
5. Using a designated stamping office.
6. Including declaration or binder pages with the surplus lines tax filings.
7. Filing a report stating that no policies were written that are known as "zero reports" (as discussed later in this section).

In order for a producer to place business in the surplus lines market, the producer must first determine that the company is an eligible surplus lines company in a given state. Most of the states require that a surplus lines company be deemed "eligible" by meeting certain financial criteria or by having been designated as "eligible" on a state-maintained list. Prior to the enactment of the NRRA, state eligibility standards varied widely from state to state.

As of July 21, 2011, a surplus lines transaction is subject only to the eligibility requirements of the NRRA. The NRRA eligibility requirements are based on two provisions from the *Nonadmitted Insurance Model Act* (*#870*).

Specifically, the NRRA requires surplus lines carriers to comply with Section 5A(2) and Section 5C(2)(a) from *Model #870*, which require an insurer to be authorized in its domiciliary state to write the type of insurance that it writes as surplus lines coverage in the state where it is eligible and to have capital and surplus, or its equivalent, under the laws of its domiciliary jurisdiction, equaling the greater of: 1) the minimum capital and surplus requirements under the law of the home state of the insured; or 2) $15 million. The insurance commissioner in the insured's home state may reduce or waive the capital and surplus requirements (down to a minimum of $4.5 million) after the insurance commissioner makes a finding of eligibility based on several factors set out in *Model #870*, such as the quality of management, the surplus of a parent company and reputation within the industry.

In addition to eligibility requirements for U.S. domiciled insurers, the NRRA requires the states to permit the placement of surplus lines coverage with surplus lines companies organized in a foreign country (alien insurers) that are listed on the NAIC *Quarterly Listing of Alien Insurers*. The states cannot prohibit a broker from making a placement with an NAIC-listed alien insurer. A state also may allow placement of coverage with alien insurers not on the NAIC list. A number of the states have authority to individually approve an alien carrier that is not listed on the *Quarterly Listing of Alien Insurers*.

The Quarterly Listing of Alien Insurers is available for reference and download on the NAIC Products – AVS, Data & Publications website at http://www.naic.org/prod_serv_alpha_listing.htm# (Quarterly Listing of Alien Insurers)

Premium Taxes

Surplus lines premium tax generally is the obligation of either the policyholder or the surplus lines producer, depending on the applicable state law. In all states, the producer or the insured, rather than the insurance company, remits the surplus lines tax. If the policy covers risks that are located entirely in one state, the tax is assessed at that state's tax rate.

Under the NRRA, the home state of the insured has sole regulatory authority over the collection of surplus lines premium taxes. The NRRA prohibits any state other than the home state of the insured from requiring any premium tax payment for surplus lines insurance.

The NRRA permitted, but did not require, allocation of the surplus lines taxes among the states where the exposure was located. The states initially pursued three different approaches to allocation of taxes following the adoption of the NRRA: 1) the Nonadmitted Insurance Multi-State Agreement (NIMA); 2) the Surplus Lines Insurance Multi-State Compliance Compact (SLIMPACT); and 3) taxing and keeping 100% of surplus lines premium tax on policies in the home state of insureds. NIMA is no longer operational and SLIMPACT never became operational. The prevailing rule is that states are taxing and keeping 100% of the premium. The NRRA requires surplus lines brokers to adhere to the law of the home state of the insured to determine the amount of premium tax owed on a surplus lines transaction and for any other regulatory requirements the state may require in connection with the payment of the premium tax, such as the timing of tax payments and whether the state requires the submission of risk allocation information for multi-state transactions. The NRRA requires surplus lines brokers to submit the premium tax payment on a surplus lines transaction only to the insured's home state. In the case of a state that has joined NIMA, the payment will be made to the clearinghouse in accordance with the home state's law. Should SLIMPACT become operational, it also could elect to require multistate payments to be made to the clearinghouse.

Many of the states require brokers to submit documentation regarding allocation by state of the risks covered by a surplus lines transaction. If the home state of the insured is a state that has joined NIMA, the broker will be required to use the NIMA risk-allocation formula. If the home state is a state that has joined SLIMPACT, the broker will be required to use the SLIMPACT risk-allocation formula. As of May 2013, both NIMA and SLIMPACT have adopted the same allocation formula. Other states require the broker to submit allocation data in accordance with individual state laws and regulations, but the vast majority of states do not require allocation data because there are very few states allocating premium at this time. In some of the states, taxes are paid to a state agency other than the insurance department, such as the department of revenue.

Guaranty Fund Warning

Nearly all of the states require a disclosure regarding the unavailability of guaranty fund coverage for a surplus lines policyholder, even if the state represents a small portion of the risk. Prior to the NRRA, when a multistate risk was involved, the company would be required to include several pages of guaranty fund notices, many of which had nearly the same language with minor variations. Brokers may choose to continue to use this approach following the enactment of the NRRA, but the NRRA initiated a compliance system that requires compliance only with laws of the home state of the insured.

As an example, a typical disclosure statement is as follows:

NOTICE TO POLICYHOLDER

> **This contract is issued, pursuant to Section ___ of the (State) Insurance Code, by a company not authorized and licensed to transact business in (State), and as such, is not covered by the (State) Insurance Guaranty Fund.**

After review of this and other issues by a special NAIC subgroup in 2006, the Producer Licensing (EX) Working Group adopted its recommendation that, on a multistate risk, the home state's disclosure should fulfill all other states' disclosure requirements.

Stamping Offices

Stamping offices are entities that are not governmental agencies but whose existence is authorized by law. These offices act as the liaison between the surplus lines producer and the state insurance departments. The stamping offices have varied responsibilities, which may include evaluation of insurance companies for inclusion on a white list, review of surplus lines policies and education. Stamping offices also provide reports of premiums and taxes to the state insurance department.

Stamping offices are nonprofit and are funded by stamping fees assessed on each policy of surplus lines insurance written in the state. As of April 2017, there are stamping offices in 14 states.

Zero Reports

In some of the states, a producer is required to file a report, known as a "zero report," stating that the producer has not placed any SLI business during a specified time period.

In 2006, a special NAIC study group documented that five states require this report monthly, 12 quarterly, seven semi-annually and 27 annually. The states also use the reports for different recording purposes, so it was not determined if it would be possible to eliminate these reports altogether. However, the study group concluded and recommended to the Producer Licensing (EX) Working Group that zero reports be eliminated. The group also recommended further study to determine feasibility of any other use of a zero report. As of January 2017, the Producer Licensing (EX) Working Group has not taken any formal action on this issue.