EXPECT FOCUS®

LEGAL ISSUES & DEVELOPMENTS FROM JORDEN BURT LLP

VOLUME III SUMMER 2013

In This Issue:

Feeling Boxed In?

Coping with regulatory scrutiny

JORDEN BURT LLP
25TH ANNIVERSARY

EXPECTFOCUS® VOL. III SUMMER 2013

EXPECTFOCUS® is a quarterly review of developments in the insurance and financial services industry, provided on a complimentary basis to clients and friends of Jorden Burt LLP.

Subscriptions

Changes in address or requests for subscription information should be submitted to:

Lauriell Webb
lwe@jordenusa.com

New York Department of Financial Services Reports On Captive Reinsurance, Pending NAIC Inquiry

BY ROLLIE GOSS

The New York Department of Financial Services' recently released report, "Shining A Light On Shadow Insurance: A Little-Known Loophole That Puts Insurance Policyholders And Taxpayers At Greater Risk," (the NY Report), describes an investigation by the New York Department into the practice of reinsuring term and universal life insurance policies with non-New York domiciled captive reinsurers which are subject to "looser reserve and regulatory requirements." The NY Report pledges to continue the investigation, urges the NAIC to develop enhanced disclosure requirements for "shadow insurance," recommends the Federal Insurance Office (FIO) and the NAIC to conduct a "similar investigation," and suggests "an immediate national moratorium on approving additional shadow insurance transactions until those investigations are complete …." **Independent of this report, the Department has for some time had the ability to address any concern that risks written by New York domiciled companies are being inappropriately reinsured with companies domiciled outside the State of New York by denying the insurers that it regulates financial statement credit for such reinsurance.**

As reported previously in *Expect Focus*, the NAIC formed a special working group of the Financial Condition (E) Committee prior to the start of the New York investigation, which has been investigating the use of captives, including the possible use of captives to evade regulatory accounting rules concerning reserves. The working group, of which the Department has been an active member, approved a White Paper containing its recommendations on June 6, 2013, less than a week before the release of the NY Report, which inexplicably failed even to mention the existence of the NAIC's on-going inquiry. The NAIC's Executive Committee and Plenary have since adopted the White Paper. Implementation of the recommendations of the White Paper have been assigned as follows: (1) review of specific captive transactions by the Financial Analysis Working Group; (2) consideration of reserving issues by the Principle-Based Reserving Implementation Task Force; (3) consideration of disclosure issues by the Blanks Working Group; and (4) consideration of other issues by the Reinsurance Task Force. The FIO had established a task force in this area before the NY Report recommended it do so.

The insurance commissioners of Delaware, Louisiana (the current NAIC President) and Tennessee have, according to news reports, rejected the call in the NY Report for a moratorium on transactions involving captives, stating that: (1) many transactions engaged in by captives are appropriate and lawful, not involving the "shadow insurance" allegations contained in the NY Report; (2) captives can be regulated properly, if necessary with additional resources applied by the state insurance departments; and (3) the current NAIC captives initiative will continue and proceed to a proper conclusion.

CONTENTS

Insurer Beware: California UCL Claims May Be Based on UIPA Violations

BY TODD WILLIS

Recently in *Zhang v. Superior Court*, the California Supreme Court addressed a long-standing question of California jurisprudence: whether insurance practices that violate California's Unfair Insurance Practices Act (UIPA) can support a cause of action under California's Unfair Competition Law (UCL). Much debate has surrounded this issue since the California Supreme Court decided in *Moradi-Shalal v. Fireman's Fund* that because the Legislature did not intend to create a private cause of action for violations of the UIPA, that prohibition could not be circumvented by instead bringing the claim under the UCL. After the *Moradi-Shalal* decision, the California Courts of Appeal split over the viability of UCL claims based on insurer conduct covered by Section 790.03 – in particular, the issue whether first party UCL actions based on grounds independent from the UIPA were precluded, even when the insurer's conduct also violated the UIPA.

The plaintiff in *Zhang* brought such a first party UCL action, alleging that the insurer "engaged in unfair, deceptive, untrue, and/or misleading advertising by promising to provide timely coverage in the event of a compensable loss, when it had no intention of paying the true value of its insureds' covered claims." The defendant moved to dismiss the UCL claim, asserting that it was an impermissible attempt to plead around *Moradi-Shalal's* bar against private actions for unfair insurance practices under the UIPA (i.e., improper claims handling), noting that the UIPA prohibited false advertising, dilatory claims handling and bad faith settlement practices. The California Supreme Court held that "when insurers engage in conduct that violates both the UIPA and obligations imposed by other statutes or the common law, a UCL action may lie. The Legislature did not intend the UIPA to operate as a shield against any civil liability."

Favorable Revenue Sharing Decision by the Seventh Circuit

BY DAWN WILLIAMS

A profit sharing plan brought a putative class action against American United Life (AUL) in *Leimkuehler v. Am. United Life Ins. Co.* for purportedly sharing revenues with mutual fund companies in connection with the variable annuity it offered to plan participants, alleging that AUL breached its fiduciary duties under ERISA. The Seventh Circuit of Appeals disagreed, affirming the grant of summary judgment in favor of AUL and holding that AUL was not acting as a functional fiduciary when it made decisions about, or engaged in, revenue sharing.

The plan first argued that AUL was a fiduciary because it decided which mutual funds and share classes to offer. Pointing to its earlier decision in *Hecker v. Deere*, the court opined that the act of selecting which funds should be included in a 401(k) product, without more, does not give rise to fiduciary responsibility.

Fiduciary status, the plan next alleged, arose from AUL's maintenance of a separate account. The court agreed in part, finding that **a party can be a fiduciary simply by exercising any authority or control – not necessarily discretionary – regarding the management or disposition of assets. However, the court said that such a party would be a fiduciary only to the extent of its authority or control**. Because the complained-of actions did not implicate AUL's control over the separate account, AUL was not a fiduciary under the circumstances of this case.

In its amicus brief in support of plaintiff-appellant, the Department of Labor suggested that AUL was a fiduciary because it had a right to delete or substitute the funds the trustee selected. Since AUL was only a fiduciary to the extent it exercised its contractual authority, and neither of the two occasions on which it exercised that right gave rise to the claims at issue, the court found that no fiduciary responsibility arose from the allegations in this case.

RAA Putative Class Dismissal Affirmed

BY ROLLIE GOSS & KRISTIN SHEPARD

In recently affirming an Illinois district court's dismissal of putative class action claims, the Seventh Circuit Court of Appeals appears to have written the final chapter in a case initially filed in state court. In *Phillips v. Prudential Financial*, removed to federal court under CAFA, plaintiff alleged that the insurer breached the terms of its life insurance policies by making a retained asset account (RAA) the default claims payment method. The district court granted the insurer's motion to dismiss plaintiff's claims for breach of contract, breach of fiduciary duty, and "vexatious and unreasonable" delay of claim settlement under Illinois statute; plaintiff appealed. On May 6, 2013, the Seventh Circuit affirmed.

> Insurer was not obligated to keep plaintiff's funds in a separate account or invest them for plaintiff's benefit.

In affirming dismissal of the contract claim, the Court found that the policy allowed plaintiff to elect either a lump sum payment or any other settlement method that the insurer made available. Although the claim form provided that the RAA would be the default payment method, the form included a blank where plaintiff could specify and elect any other payment option allowed by the policy. Thus, the Court found that the claim form did – "albeit vaguely" – offer a lump sum payment option. **The Court found that the relationship between the insurer and plaintiff with regard to the RAA was "nothing more than a debtor-creditor relationship" which was not fiduciary in nature** and did not obligate the insurer to keep plaintiff's funds in a separate account or to invest them for plaintiff's benefit.

With respect to the statutory claim, the court found that the payment mode was not "vexatious or unreasonable," as plaintiff did not allege that the insurer unreasonably delayed issuing the checkbook or honoring checks written against the RAA. The Court cautioned that, in affirming the dismissal of plaintiff's claims, it was not endorsing the insurer's RAA practices: "[w]hether this practice is disreputable is open to debate – state insurance regulators are entitled to conclude that the practice should be limited or restricted... ."

Unclaimed Property Update: Death Master File as Holy Grail?

BY ANTHONY CICCHETTI

The second quarter of 2013 saw more developments on the unclaimed property front, including activity centered on the Social Security Administration's (SSA) Death Master File (DMF).

Legislative and Regulatory

On May 8, 2013, the **U.S. GAO** issued its "Preliminary Observations on the Death Master File," addressing: (i) SSA's process for handling death reports for inclusion in the DMF, and (ii) federal agency access to the DMF. It leads off with the following characterization of the DMF's shortcomings: "The … procedures for handling and verifying death reports may allow for erroneous death information in the [DMF] because SSA does not verify certain death reports or record others." Notably, the GAO explained that it undertook the review because the federal government uses the DMF to "safeguard[] against improper payments," conduct for which life insurers have been criticized by state regulators and the press. The GAO plans to issue its final report later this year.

The **Treasury Department** has proposed limits to **DMF** access that would make information concerning a decedent unavailable to non-certified private parties for three years.

Additional settlements were announced in May and June, including a **California**-led, multi-state settlement involving 11 companies, and **Minnesota's** settlement with another. **New York** recently reported that the investigation of unpaid insurance benefits has led to recovery of $386 million in New York and more than one billion dollars nationally.

Litigation

California in early May sued American National Insurance Company, claiming that the company unlawfully failed to cooperate with an unclaimed property examination when it refused to provide certain records concerning in-force policies.

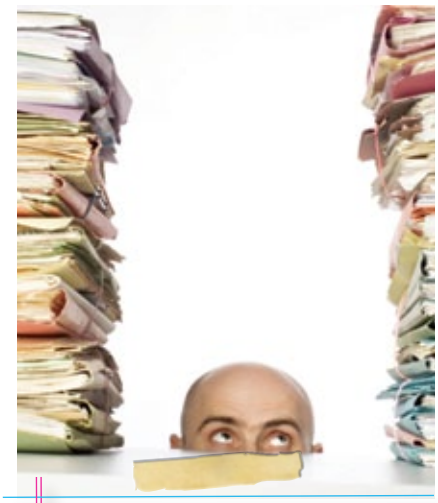
West Virginia's Treasurer in 2012 sued 69 life insurance companies, alleging that they breached an implied good faith obligation to search the DMF to identify deceased insureds and attendant obligations to pay death benefits or escheat funds as unclaimed property. The defendant companies expect a hearing on their motions to dismiss in late summer or early fall of 2013.

Kentucky's enactment of an Unclaimed Life Insurance Benefits Act was challenged last year in *United Insurance Company of America et al. v. Commonwealth of Kentucky*. Whether the Act could lawfully apply to policies issued prior to the Act's effective date is the central issue. The companies have appealed the court's April 1 grant of summary judgment to Kentucky and sought a stay of enforcement of the Act pending the appeal.

Illustration Subclass Decertified in EIUL Litigation

BY DAWN WILLIAMS

Citing the "Herculean task" of reviewing nearly nine million pages of policy files, the federal district court in California decertified a subclass of equity-indexed universal life insurance policyholders who received illustrations. In *Walker v. Life Ins. Co. of the Southwest*, the class and subclass were certified over six months ago, and at that time the court opined that it could ascertain the members of the subclass through the use of a special master and a questionnaire. The defendant asked the judge to reconsider, and in April the court issued an Order to Show Cause why the subclass should not be decertified.



Seeing piles and piles of paper to review gave the court second thoughts

The evidence submitted by the parties indicated that the special master would need to review approximately 42,000 policy files, which would take roughly five years to even determine subclass membership. Plaintiffs submitted numerous proposals for easing the burden of manual file review; however, the court noted that even assuming there could be some aid by electronic means and administrative personnel, **"the individualized issues created by a review of 42,000 files predominate over the issues common to the subclass."**

The ruling eviscerates plaintiffs' theories of liability based on alleged nondisclosures in the illustrations, such as that the insurer should have disclosed the existence, amount and impact of various fees and charges. The remaining allegations center on purported defects in the products themselves, including that the interaction between the policy design and market volatility creates a significant risk that the policy will lapse or suffer reduced value, and that policyholders will be required to pay substantial taxes if they have outstanding loans at the time of surrender.

Scribner, Hall & Thompson, LLP

Proposed Regulations for I.R.C. § 162(m)(6) Compensation Deduction Limit Fail to Provide Needed Clarification

BY SUSAN HOTINE

The proposed regulations (REG-106796-12) recently released by the IRS on the compensation deduction limitation under I.R.C. § 162(m)(6) for employees of covered health insurance providers raise more ambiguities for life insurance companies. I.R.C. § 162(m)(6), enacted as part of the Affordable Care Act (Pub. L. No. 111-148), limits such deduction to $500,000, and the limitation applies to health insurance issuers if at least 25 percent of their gross premiums is received for health insurance coverage is attributable to minimum essential coverage (doctor and medical). Because the deduction limitation is broadly written and applies to all members of an aggregated group, life insurance companies that sell small amounts of health insurance or carry legacy health insurance business could be subject to it. Some relief is provided by a de minimus rule set forth in Notice 2011-02, which excludes companies from the deduction limitation when gross premiums from health insurance coverage are less than two percent of the company's gross revenues for the taxable year. The term "gross revenues" presumably means something different from gross premiums and also something different from gross income.

However, neither the notice nor, now, the proposed regulations define or clarify the term "gross revenues." Instead, the proposed regulations require gross revenues to be determined in accordance with "generally accepted accounting principles," which just added more ambiguity. From a financial accounting perspective, "generally accepted accounting principles" means U.S. GAAP. Do the regulations require the taxpayer to use GAAP rules to determine gross revenue rather than tax accounting principles? Does the directive to use generally accepted accounting principles refer to something other than tax accounting principles? One might have assumed that gross revenues (like gross premiums and gross income) should be determined using tax accounting principles but leaving that question of what should be included — investment income? tax exempt interest? decrease in reserve amounts? Now, the insurance industry also needs clarification regarding what is meant by "generally accepted accounting principles."

New Assignments Being Handed Out at the NAIC

BY ANN BLACK

As the new school year is starting, new assignments in a variety of subject areas are being handed out to various groups within the National Association of Insurance Commissioners. These include:

- **Corporate Governance:** During its July 26th joint conference call, the NAIC Executive Committee and Plenary approved the development of the "Annual Reporting of Corporate Governance Practices of Insurers Model Act" to provide regulators a means to better understand the governance practices of their domestic insurers. During its August 25th meeting, the Corporate Governance (E) Working Group reviewed a draft proposal from industry leaders and discussed a timeline to prepare the model for adoption at the Fall National Meeting.

- **Captive Reinsurance:** Following its adoption of the *Captive and Special Purpose Vehicles White Paper*, the Financial Condition (E) Committee referred several of the recommendations made in the White Paper for further consideration to the Principle-Based Reserving (EX) Task Force and to the Reinsurance (E) Task Force. In addition, the E Committee is seeking to have the Financial Analysis (E) Working Group perform reviews of transactions involving affiliated captives or other vehicle used to reinsure XXX and/or AXXX reserves.

- **Contingent Deferred Annuities (CDAs):** On August 25, 2013, the Life and Annuities (A) Committee exposed for comment revised proposed charges for various groups within the NAIC to (i) assess whether changes are needed to existing models to clarify their applicability to CDAs and (ii) assess whether AG 43 and risk-based capital guidance would be deficient when applied to CDAs. The charges also included the development of a work plan by the (A) Committee to track all the progress of the NAIC groups on the various charges.

Looks like lots of homework for the various groups in the NAIC.

Financial Modernization Update

BY ROLLIE GOSS

The Financial Stability Oversight Council has published its initial listing of companies designated as systemically important financial institutions, which will trigger "enhanced prudential regulation" by the Federal Reserve. Prudential Financial, GE Capital and American International Group, Inc. were included. Prudential reportedly is challenging the designation, while GE and AIG are not.

On July 2, the Federal Reserve, OCC and FDIC released a final rule regarding regulatory capital, which implements Basel III for banks and certain provisions of the Dodd-Frank Act. The proposed rule would have applied these stringent capital and other financial standards to some insurance companies or insurance operations, potentially leading to financial hardship and conflicts with state regulation. There has been concern in the insurance industry, for example, that the rule might apply to insurance companies which had acquired a savings and loan. **The regulators have at least temporarily excluded certain insurance companies and savings and loans with 25% or more of their assets involved in insurance operations from the final rule, pending further consideration by the regulators.** The 972-page final rule is complicated, and the insurance "exclusion" is subject to interpretation in several respects. Moreover, there are special sections of the final rule dealing with policy loans, separate accounts, insurance underwriting subsidiaries, hedging and other activities which may be of interest to some of our readers. While not a definitive "win" for insurance interests, it does constitute considerable progress along this regulatory path.

LTC Insurance Update: Failure to Pay Claims a Form of Elder Abuse?

BY JASON KAIRELLA & CLIFTON GRUHN

While litigation over long-term care insurance policies generally centers around breach of contract and fraud theories, a putative class in Oregon is testing the novel claim that failure to pay claims constitutes elder abuse. In *Bates v. Bankers Life & Casualty Company*, the named plaintiffs claim that the defendant insurer caused them harm through its failure to "implement standards designed to safeguard the rights and interests of plaintiffs" and allegedly unwarranted claims denials.

The named plaintiffs, all of whom are over the age of 65, seek a broad reading of Oregon's elder abuse statute. Plaintiffs maintain that, among other things, the Oregon statute prohibits: a) refusing to play claims without an investigation; b) forcing claimants to initiate litigation to recover benefits; c) failing to return phone calls; d) insufficiently organizing, maintaining, and storing claim applications; and e) losing claim forms. Plaintiffs further allege that these actions caused significant economic and noneconomic harm to elderly policy holders.

Plaintiffs' theory has yet to be tested, but it adds a new wrinkle to long-term care litigation. **And while this argument may ultimately prove unsuccessful under Oregon's particular elder abuse statute, plaintiffs in other jurisdictions may proffer similar theories under different elder abuse statutes.** Indeed, with the prospect of recovering treble damages and attorneys' fees under elder abuse laws similar to the statute in Oregon, there is a strong incentive for plaintiffs to test the waters with elder abuse theories.

Automated Review of Medical Bills: Big Questions Remain

BY BERT HELFAND

Automobile insurance policies that provide Medical Payments (Medpay) or Personal Injury Protection (PIP) coverage typically require insurers to pay the "reasonable" cost of medical services, and they usually permit medical providers to submit bills directly to insurers. These terms raise basic questions. Can a charge be "unreasonable" because it is too high? (Insurers contend that it can be—especially since limits on Medpay coverage are often as low as $10,000.) If so, may insurers use automated data systems to help determine reasonableness? (Providers claim these systems unreasonably override the judgment and experience of claims professionals.) If an insurer pays less than a medical provider charges, and the insured is not billed for the balance, has the insured suffered harm? (Class action attorneys say yes, because the insured remains liable; insurers say they conferred a *benefit*, extending the value of the insured's Medpay coverage.)

Although putative class actions have been challenging insurers' use of automated systems to review medical bills for over a decade, none of these questions has received a definitive answer. In 2009, in *St. Louis Park Chiropractic v. Federal Ins. Co.*, the Third Circuit Court of Appeals held that ***certain* policies did not prohibit any particular method of bill review, but it also acknowledged that different policy language or state law could mandate a different result.** In July 2013, in *Halvorson v. Auto-Owners Ins. Co.*, the Eighth Circuit Court of Appeals held that **an insured suffers no injury where the provider has "accepted" a reduced medical payment, but it did not explain how "acceptance" could be established.**

It now appears these questions will never be finally resolved. Despite some victories for plaintiffs (notably in Oregon and Oklahoma), courts seem increasingly inclined to reject these cases on procedural grounds. In *State Farm Mut. Auto. Ins. Co. v. Reyher*, in 2011, the Supreme Court of Colorado reversed a decision to certify a class, finding that the trial court could not accept "at face value" an allegation that the insurer relied "solely" on the automated system. In 2012, in *Shipley v. St. Paul Fire & Marine Ins. Co.*, the Appellate Court for the Fifth District of Illinois held that a challenge to the review of medical bills could not satisfy the commonality requirement articulated by the state's Supreme Court in *State Farm Mut. Auto. Ins. Co. v. Avery*. In *Halvorson*, the most recent decision, the Eighth Circuit found that a similar case failed to satisfy the "predominance" requirement of Federal Rule 23(b)(3).

Halvorson presented a typical scenario: Auto-Owners subjects medical bills to an automated review that employs a data base of charges for medical services in different geographic areas. If a given charge exceeds the 80th percentile (a level selected by the insurer) for charges in the same area—that is, if the price is more than what providers charge voluntarily on 80% of the bills submitted in that area—Auto-Owners pays only the 80th-percentile amount, but it also permits aggrieved providers to object to the reduction and ask for full payment. Plaintiffs asserted that Auto-Owners routinely pays less than the reasonable cost of medical services, and the district court certified a North Dakota class consisting of *both* insureds and their providers.

> It now appears these questions will never be finally resolved.

To satisfy the predominance requirement of Rule 23(b)(3), the Eighth Circuit explained, plaintiffs must be able to make a prima facie showing of liability to all class members on the basis of common evidence. In this case, it found that liability to any member of the putative class would depend on whether the individual charges *for that class member* were "reasonable." The court held that these individual inquiries would predominate over the common question of whether Auto-Owners used a reasonable process to pay claims, and it reversed the order certifying the class.

NY Court's Blockbuster Ruling on the Duty to Defend Tells Insurers They Should Forego Even Strong Policy Arguments

BY JOHN PITBLADO & BERT HELFAND

In *K2 Inv. Group, LLC v. American Guarantee & Liability Ins. Co.* New York's Court of Appeals found two different ways to "give [liability] insurers an incentive" to defend policyholders who get sued. One was the holding the high court announced in June that an insurer that breaches a duty to defend thereby forfeits the right to assert even valid coverage exclusions as a defense to indemnification. Insurers should also take note, however, of the circumstances that produced this ruling: as the court itself acknowledged, "it may well have been reasonable" for the insurer to believe its policy did not apply to the underlying claim.

The plaintiffs in *K2* loaned $2.83 million to Goldan, LLC. Goldan agreed to secure the loans with a mortgage, but one of Goldan's owners, Jeffery Daniels, failed to record that mortgage. When Goldan defaulted, the plaintiffs sued on a number of grounds, including the theory that Daniels had acted as their attorney in the transaction and had committed malpractice.

Daniels had $2 million in professional liability coverage, but his carrier, American Guarantee, refused to provide a defense, on the ground that the plaintiffs' claims were not, in fact, "based on the rendering … [of] legal services for others." The denial also relied on two policy exclusions, which provided that "[t]his policy shall not apply to" claims arising out of Daniels' (a) status as shareholder of a business enterprise or (b) acts or omissions for any business in which he had a controlling interest. When Daniels first gave notice of his claim, he expressly admitted that it arose "as a result of legal services that I have rendered to …Goldan," i.e., a business he owned.

Relying on these grounds, American Guarantee rejected the plaintiffs' $450,000 settlement demand. Daniels then defaulted in the malpractice action, and judgment was entered against him for over $3 million. Goldan was now insolvent, and plaintiffs discontinued their other claims. Using New York's direct action statute, they sued American Guarantee for breach of contract and bad faith.

The trial court awarded plaintiffs summary judgment on their breach of contract claims, and an intermediate appellate court affirmed. In New York, it explained, "the duty to defend is generally measured against the allegations of the pleadings in the underlying action." The underlying complaint clearly alleged that Daniels had failed to record the mortgage while rendering legal services for the plaintiffs. Furthermore, a policy exclusion can relieve an insurer of its duty only if "the allegations … cast the pleadings wholly within that exclusion … and there is no possible … basis upon which the insurer might be eventually obligated to indemnify." Without any further discussion, the court ruled that the underlying allegations were not based, "even in part," on Daniels' actions as a principal, or on behalf of, Goldan.

The Court of Appeals was even more dismissive of the exclusions as a basis for denying a defense, stating only that "[i]t is quite clear that American Guarantee breached its duty." Thus, while it affirmed dismissal of the claim that the insurer had rejected plaintiffs' settlement offer in bad faith—on the ground that "it may well have been reasonable" to believe "the malpractice claim lacked any merit"—it also upheld the plaintiffs' judgment for breach of contract.

The court then proceeded to break new legal ground: Even though the duty to defend is broader than the duty to indemnify, the court held that an insurer that breaches the duty to defend loses the right to rely on policy exclusions as a defense against indemnification. The court characterized its decision as a clarification of its 2004 decision in *Lang v. Hanover Ins. Co.*, in which it stated that an insurer that disclaims its duty to defend "may litigate only the validity of its disclaimer."

Thus, based on a finding that it breached its duty to defend, American Guaranty was held liable to pay a claim that its policy expressly excluded. The substance of that ruling is important, but it is also important to remember that the finding of a breach came in a case in which the insured had essentially admitted that the underlying claim was excluded from coverage. In the future, New York plaintiffs are likely to take even greater care in crafting complaints against insured defendants, and liability carriers will have to be equally careful before refusing to defend those claims.

The Fed's Strict New Capital Rules Won't Apply to Insurers – Yet

BY ELIZABETH BOHN

Proposed regulatory framework might not be an ideal fit for everyone.

On July 2, the federal banking regulators—the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation—approved final rules implementing changes to banking capital required by the Dodd-Frank Act. The new rules also reflect international agreements reached by the Basel Committee on Banking Supervision (known as Basel III), which created voluntary regulatory standards on bank capital adequacy, stress testing and market liquidity risk in response to the financial crisis of late 2008. Following extensive public comments, however, the agencies modified the rule that was originally proposed by exempting (for the time being) savings and loan holding companies with significant commercial and insurance underwriting activities.

The Basel III regulations specifically target systemically important financial institutions (SIFI)—institutions that are "Too Big to Fail." In the United States, a SIFI is a bank, insurance company or other financial institution whose failure might trigger a financial crisis, as determined by the Financial Stability Oversight Council (FSOC) created by Dodd-Frank. Like Basel III, Dodd-Frank also provides for enhanced prudential regulation of SIFIs, as well as of bank holding companies with over $50 billion in assets. While Dodd-Frank expressly excludes "the business of insurance" from the scope of its requirements, those requirements do apply to bank holding companies that engage in underwriting activities or own interests in insurers.

The new rules increase the quantity and improve the quality of the regulatory capital of U.S. banks, by setting strict eligibility criteria for regulatory capital instruments, and by raising minimum capital ratios. They also require a capital conservation buffer of 2.5 percent of risk-weighted assets. This ensures that banking organizations build capital during benign economic periods, so that they can withstand serious economic downturns. For the first time, the new capital rules also apply risk-based and leverage capital requirements to certain savings and loan holding companies.

> For the first time, the new capital rules also apply risk-based and leverage capital requirements to certain savings and loan holding companies.

The final rule's exemption for holding companies with insurance operations reflects concern that the proposed regulatory capital framework might not be appropriate for insurance business models. In fact, concern about the proposed rule appears to have led some bank holding companies to divest themselves of insurance subsidiaries, to avoid application of bank capital requirements to those subsidiaries. (Similar concern also appears to have caused some insurance companies to sell their savings and loans or insured deposits business.)

But the final rule is not the last word: The Fed will now take additional time to evaluate the appropriate regulatory capital framework for these currently-exempted entities, and it may well issue capital regulations on insurers that are determined to be SIFIs at some point down the road. To the extent those insurers are *not* subsidiaries of bank holding companies, the industry can be expected to challenge such regulations as infringements on the state regulatory insurance scheme provided by the McCarran-Ferguson Act.

A crucial transition period has begun for certain standardized derivatives (or swaps) that historically have traded over-the-counter and are subject to clearing requirements under the Dodd-Frank Act. Under Dodd-Frank, all transactions in such swaps will soon be required to be on designated contract markets (DCMs) or swap execution facilities (SEFs).

On May 16, 2013, the CFTC adopted a final rule that establishes a comprehensive definitional and regulatory scheme that is intended to enable SEFs to operate as contemplated by Dodd-Frank. On the same day, the CFTC also adopted a final rule laying out the processes for a swap to be made "available to trade" on a DCM or SEF. Specifically, as to each swap it wants to make available to trade, the DCM or SEF must make submission to the CFTC for approval or for self determination by the DCM/SEF of such availability. Under either of these processes the CFTC has a period of time to object and preclude "available to trade" status.

However, once a swap has been approved as available to trade by the CFTC (or deemed certified under the self determination procedure), a 30-day implementation period begins; and any transaction in that swap after the implementation period (or, if later, the date the clearing requirement is applicable to that transaction) must be on a DCM or SEF, and over-the-counter trading in that swap will no longer be permitted. It is expected that the earliest such transition date mandated for any swap will be late this year.

Institutional investors such as investment companies and insurance companies may be significantly impacted by the move from over-the-counter trading to DCMs and SEFs. For example, such firms often use standardized types of interest rate and broad-based index swaps that will be mandated for trading on a DCM or SEF.

Institutional investors may benefit from the increased transparency and pricing efficiency that trading on a DCM or SEF is intended to promote. On the other hand, swap transactions that are required to be cleared (including those approved to trade on a DCM or SEF) will have margin requirements that impose greater capital costs on investors (including investment companies and insurance companies) than uncleared over-the-counter swap transactions historically have imposed, and this increased cost may be very significant.

Also on May 16, 2013, the CFTC adopted another final rule under Dodd-Frank that allows swap transactions that exceed prescribed "block trade" size thresholds to avoid some of the consequences that otherwise would result from the transactions' being required to be on a DCM or SEF. For example, public dissemination of data about the transaction could be delayed somewhat, and other DCM or SEF trading and execution requirements could also be relaxed. The option for such alternative treatment for block trade-size transactions is likely to be most relevant for large institutional type investors, including insurance companies and mutual funds.

The three rules discussed above that the CFTC finalized on May 16 relate only to the types of swaps that it regulates. The SEC has proposed similar rules for the types of swaps that it regulates (known as security-based swaps), but the SEC has not yet finalized its rules.

Financial Firms Brace for New Swap Trading Requirements

BY TOM LAUERMAN

Finally, pursuant to Dodd-Frank, the CFTC and other regulators also have proposed margin requirements for those non-standardized swaps that will be permitted to continue trading on an uncleared basis. The volume of transactions in such non-standardized swaps is very great, and there is considerable pressure for additional margin requirements thereon among both U.S. and foreign regulators. When and if such requirements are finalized, the capital cost associated with such uncleared swaps might very well increase substantially, thus closing their capital cost advantage in comparison to cleared swaps (including swaps available to trade on a DCM or SEF).

> Swap transactions that are required to be cleared have margin requirements that impose greater costs on investors such as insurance companies and investment funds.

SEC Stirs Money Market Reform Pot

BY TOM LAUERMAN

The money market fund (MMF) reforms that the SEC published in June have evoked a broad range of initial reactions.

As to the SEC's proposal to require MMFs used by large investors (other than U.S. government MMFs) to adopt a "floating" net asset value per share (NAV), for example, Fed Chairman Ben Bernanke has publicly stated that the SEC is "moving in the right direction." Likewise, Charles Schwab & Co. has confirmed on its website that it regards this floating NAV proposal as a much better outcome for individual investors than an earlier proposal that would also have required MMFs used by smaller investors (i.e., "retail" MMFs) to float their NAVs. Schwab's reaction is no surprise, because Schwab's CEO put forth a very comparable proposal last fall for "institutional" (but not retail) non-U.S. government MMFs to float their NAVs. There are reports that several other major MMF sponsors are also now willing to accept such a floating NAV requirement.

By contrast, the President of the Investment Company Institute has stated that the ICI remains opposed to a floating NAV requirement for any type MMF, and many MMF sponsors feel the same way.

The SEC's proposal also puts forth liquidity "fees" or "gates" as alternatives to (or possibly in addition to) its floating NAV proposal. These are redemption fees or temporary restrictions on redemption that any non-U.S. government MMF could impose during periods when its investment portfolio is experiencing reduced liquidity.

The SEC's proposal for liquidity fees/gates had its origins in suggestions made by certain MMF sponsors, and has prompted less industry opposition than the SEC's floating NAV proposal. The ICI, for example, prefers the fees/gates proposal.

Some, however, including numerous bank regulatory officials, have expressed concerns that, **paradoxically, the prospect of liquidity fees/gates being imposed could promote instability by making investors more likely to redeem their MMF investments at the slightest hint of financial stress**.

In addition to the floating NAV and liquidity fees/gates, the SEC's proposals provide for substantial additional disclosure and other operational changes that may be costly for MMFs. Accordingly, to the extent that the SEC's proposals are adopted:

- Some sponsors may cease to offer MMFs or may cease to offer certain types of MMFs (e.g., institutional prime MMFs) that might be most impacted by those reforms.
- The largest MMFs and their sponsors may have economies of scale and other competitive advantages in coping with changes required by the reforms.
- The reforms may very well enhance the relative competitive position of certain non-investment company products, such as bank deposits, repurchase agreements, commercial paper, and privately-offered "liquidity funds."
- The reforms also may enhance the competitive position of certain investment company products such as retail and U.S. government MMFs (which may be less impacted by the reforms) and ultra-short-term bond funds/ETFs (which would not be impacted at all).

Employers Warned: Hands Off Whistleblowers

BY MARILYN SPONZO

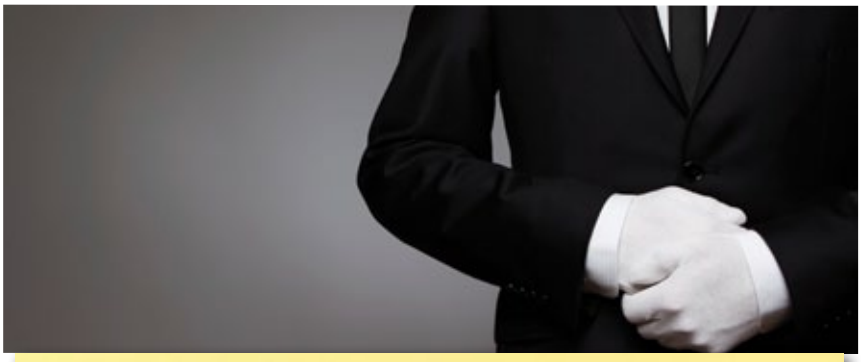
Companies attempting to thwart present or former employees from reporting potentially illegal corporate conduct face regulatory wrath, according to Sean McKessy, Chief of the SEC's Whistleblower Office. McKessy has publicly noted that **the Commission is not only investigating potentially retaliatory conduct, but also aggressive severance agreements and the lawyers who draft them**.

The SEC whistleblower reward program encourages individuals to report securities law violations, and is supported by the Dodd-Frank Act, which contains strong anti-retaliation provisions. Additionally, SEC Rule 21F-17(a) prohibits, subject to attorney-client privilege, interference with a whistleblower's communications with the SEC, and specifically targets over-broad confidentiality agreements.

The SEC has been receiving complaints, including a letter from a law firm that represents whistleblowers and that extensively discusses contractual provisions that may be viewed as improper.

In light of the SEC's concerns and admonitions, companies may wish to review their employment and severance agreements. Potentially problematic provisions include clauses that:

- Require confidentiality (other than based on attorney-client privilege) and permit an employee to divulge confidential company information only when compelled by law;
- Require an individual to forego any whistleblower reward;
- Require an employee to report to the employer any communications with the SEC or other regulatory agency related to any potential misconduct; or
- Require an employee to assist or cooperate with the employer in responding to an SEC inquiry, or otherwise authorize the employer to manage the individual's communications with regulators.



Feds stepping in to protect whistleblowers.

SEC: Enforcement Actions Against Independent Fund Directors

BY GARY COHEN

Has the SEC changed its long-standing hands-off policy for independent fund directors? Let's just say *maybe* for now.

In two recent cases, the SEC has taken enforcement action against independent directors, naming the independent directors publicly and charging them with specific violations under the Investment Company Act. Each case was settled: independent directors neither admitted nor denied culpability, but the SEC ordered them to cease and desist further violations, opting not to fine the independent directors or bar them from further service. In one of the cases, however, the Commission required the independent directors, along with the investment adviser, to foot the bill for an independent compliance consultant while, in both cases, reserving authority to seek monetary penalties against independent directors who commit further violations.

In one case that involved an underlying insurance product fund, the Northern Lights Variable Trust (and a sister fund), the SEC settled charges in connection with approving the continuance of an investment advisory agreement. Just over a month later, in a case involving funds advised by Morgan Asset Management, Inc., the SEC settled charges that Morgan failed to properly oversee valuation of fund portfolio assets.

The SEC traditionally has given independent directors the benefit of the doubt or overlooked lapses, often based on the directors' lack of knowledge about technical, financial, or legal matters. **The two recent cases illustrate the SEC's willingness to hold independent directors accountable on the basis that they knew and understood their responsibilities, but failed to act properly on that knowledge.**

A practical take-away for independent directors? Don't passively bless boilerplate language, even if it tracks SEC statements verbatim. Poke behind the language, ask questions about it, and get the answers on the record.

FINRA Favors an Easier Choice

BY ABIGAIL KORTZ & WHITNEY FORE

FINRA is proposing to make its arbitrator selection process more friendly to investors. Currently, investors who are parties to a FINRA arbitration proceeding must, within 35 days after they first file their statement of claim, choose whether they prefer a panel consisting of all public arbitrators, or a panel that includes an industry arbitrator. Many investors, particularly those not represented by counsel or a panel that includes an industry arbitrator, inadvertently fail to make this choice and, by default, are required to accept a panel composed of two public arbitrators and one industry arbitrator.

Under rule changes that FINRA is now proposing, all parties receive separate lists of ten public arbitrators eligible to serve as the panel's chair, ten other public arbitrators, and ten industry arbitrators. Each party may then strike four of the proposed arbitrators from each of the chair and other public arbitrator lists. Each party may also strike all of the proposed industry arbitrators, which would automatically result in an all public arbitrator panel. **The proposed rule change removes the 35-day requirement and substantially reduces the possibility of investors inadvertently defaulting to a panel that includes an industry arbitrator.**

According to FINRA, investors currently prevail in 49% of cases decided by all public panels and in 34% of cases decided by panels with an industry arbitrator. The proposed change is the latest in a series of modifications that may help stave off calls to curtail contractual provisions whereby firms require that all disputes with investors go to arbitration. *See, e.g.*, "Blue-Sky Regulators Attack Pre-Dispute Arbitration Agreements" in *Expect Focus*, Volume II, Spring 2013. If such contractual provisions were eliminated, the volume of FINRA arbitrations could be substantially reduced.

The changes are currently under consideration by the SEC.

Deadline for SEC Enforcement Actions Lacks Teeth

BY BEN SEESSEL & JOSH WIRTH

Section 929U of Dodd-Frank states that: "Not later than 180 days after the [issuance of] a written Wells notification to any person, the Commission staff shall either file an action against such person or provide notice to the Director of the Division of Enforcement of its intent not to file an action." In *SEC v. Nir Group, LLC*, the District Court for the Eastern District of New York recently held that this is merely an internal deadline that, if not met, does not divest the SEC of jurisdiction.

The SEC had initiated an action against the Nir Group, alleging that it misled its clients and misused their funds. Nir moved to dismiss, based on the SEC's purported failure to meet the 180-day deadline. The court, however, held that the "180-day deadline imposed by section 929U does not create a jurisdictional bar to SEC enforcement actions."

This echoed the interpretation that the District Court for the Southern District of Florida had given to 929U in an opinion earlier this year. The court in *Nir* also observed that the 929U deadline was not wholly "superfluous," because "targets of an SEC investigation that extended beyond the deadline could be entitled to initiate an administrative proceeding or file a declaratory judgment action to compel agency action."

Section 929U also contains a requirement that, upon completion of a compliance inspection, the SEC staff has only 180 days (subject to certain extensions) to request that a registrant take corrective action. The SEC can be expected to take the position that this, too, is merely an internal deadline that is, at best, difficult for a registrant to enforce against the agency.

> According to one federal district court, the 929U deadline is *internal* and does not divest the SEC of jurisdiction.

Dearth of Data on Uniform Broker-Dealer/ Investment Adviser Standard

BY ANN FURMAN & SCOTT SHINE

In March, the SEC released a massive request for the public to provide it with "quantitative data and economic analysis" relating to the cost/benefit of alternative approaches to the standards of conduct for broker-dealers and investment advisers. July 5th marked the deadline for responding to the request, which also sought input on the advisability of harmonizing other aspects of broker-dealer/investment adviser regulation.

Several weeks prior to the deadline, SEC Commissioner Elisse Walter publicly lamented that the responses had not been particularly data-heavy. Although the SEC ultimately received over 150 responses, very few included the type of cost/benefit data and analysis the SEC seems to have been seeking.

For example, one financial planning-focused trade group that urged the SEC to adopt a strong uniform fiduciary standard of conduct backed its position primarily with results of a survey of 498 registered investment advisers. More than two-thirds of those polled were in favor of a strong fiduciary standard of conduct that would apply uniformly to investment advisers and broker-dealers.

Numerous commenters favored a 2011 SEC staff recommendation for a uniform fiduciary standard of conduct for both broker-dealers and investment advisers. These letters generally argued that most retail investors do not understand what standard of conduct they should expect from financial service providers and that a uniform fiduciary standard of conduct would remove some of this confusion. However, a trade group on behalf of large broker-dealers, while supporting a uniform fiduciary standard, strongly opposed applying existing Investment Advisers Act guidance and precedents to broker-dealers.

Other commenters, including certain registered investment advisers, expressed concern that, far from removing any such confusion, making broker-dealers subject to a uniform fiduciary standard of conduct would inappropriately blur the differences in the roles of broker-dealers and investment advisers. In addition, some argued that a uniform fiduciary standard of conduct could lead to significantly increased compliance costs for registered investment advisers if they were also made to comply with the types of licensing, books and records, and supervision requirements that apply to broker-dealers.

Given the increased importance that certain federal court decisions, and the SEC itself, have recently attached to cost/benefit analysis in the rulemaking process, it is not surprising that the SEC would reach out to interested parties for quantitative data and economic analysis. However, the type of information that the SEC has received to date probably will not greatly speed up the SEC's cost/benefit analysis with respect to a uniform broker-dealer/ investment adviser fiduciary standard of conduct.

CFPB Releases Bulletin for Mitigating Enforcement Sanctions

BY: ELIZABETH BOHN

The Consumer Financial Protection Bureau (CFPB or the Bureau) recently issued guidance informing banks and other consumer financial product and service providers of what it terms "responsible conduct" which it may consider favorably in exercising its enforcement authority.

The guidance bulletin states that in exercising enforcement discretion, the CFPB will consider factors, including (1) the nature, extent, and severity of the violations; (2) the actual or potential resulting harm; (3) past violations; and (4) a party's effectiveness in addressing violations. It then details four categories of conduct which may mitigate sanctions for violations.

Self-policing: A robust compliance management system facilitating early detection of potential violations, thus limiting consumer harm, is favorably considered by the Bureau to demonstrate "a proactive commitment to prevention and early detection of potential violations of consumer financial laws."

Self-reporting: According to the bulletin, the Bureau puts special emphasis on "complete and effective" self-reporting in determining whether to provide favorable consideration for self-reporting of violations or potential violations of federal consumer financial laws, as well as complete disclosure to regulators and affected consumers.

Remediation: The Bureau says this means addressing misconduct promptly, and also includes preserving information, recompensing affected victims, and improving controls to prevent a recurrence of the violation.

Cooperation: To "receive credit for cooperation" the CFPB expects the entity to take "substantial and material steps above and beyond what the law requires" in interacting with it, including cooperating promptly and completely with the CFPB and with "other appropriate regulatory and law enforcement bodies."

The CFPB suggested that by taking such affirmative, responsible action, companies may, among other things, avoid any public enforcement action, be charged with a less severe violation, or receive a lesser penalty.

But the bulletin may deter companies from taking the initiative to self-report, as it goes to great lengths to disclaim any limitations to its discretion to enforce violations to the fullest extent of the law. Furthermore, the CFPB set a very high threshold for cooperation, as set forth above.

Thus voluntarily reporting may be an avenue to mitigate the magnitude of a CFPB enforcement action, but it is also not without risk. Rather, the bulletin may be more useful to avoid violations and prepare for examinations, as it offers no guarantee that self-reporting those violations will be met with favorable treatment.

The entire bulletin can be found here: *http://files.consumerfinance.gov/f/201306_cfpb_bulletin_responsible-conduct.pdf*.

CFPB Issues Guidance on UDAAP Prohibitions in Collection of Consumer Debts

BY ELIZABETH BOHN

In July, the Consumer Financial Protection Bureau (CFPB or Bureau) issued a bulletin clarifying Dodd-Frank's prohibition of unfair, deceptive, or abusive acts or practices (collectively, UDAAPs) in the context of consumer debt collection. Among other things, the bulletin describes acts or practices in the collection of consumer debts that could constitute UDAAPs.

While the Fair Debt Collection Practices Act (the FDCPA) generally applies only to third party debt collectors, original creditors and other covered persons and service providers involved in collecting debt related to consumer financial products or services are subject to Dodd-Frank's UDAAP prohibition. There is some overlap, however; acts or practices which may be unfair, deceptive, or abusive under Dodd-Frank are somewhat broader than the specific conduct prohibited by the FDCPA. Third party debt collectors are now subject to both the FDCPA and Dodd-Frank, while only creditors and servicers are subject to Dodd-Frank, and the UDAAP bulletin.

Dodd-Frank prohibits conduct that constitutes an "unfair, deceptive, or abusive act or practice." It states that an act or practice is "unfair" when it causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers, and which injury is not outweighed by countervailing benefits to consumers or to competition. A substantial injury typically takes the form of monetary harm, such as fees or costs paid by consumers because of the unfair act or practice.

An act, practice, representation or omission is "deceptive" under Dodd-Frank when it misleads or is likely to mislead the consumer, the consumer's interpretation is reasonable under the circumstances, and the misleading act or practice is material. In determining whether a consumer's interpretation of information was reasonable when targeted at specific audiences, such as older Americans or financially distressed consumers, the CFPB will consider the communication from the perspective of a reasonable member of the target audience.

An act or practice is "abusive" when it materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service, or takes unreasonable advantage of a consumer's lack of understanding of the risks, costs, or conditions of the product or service, inability to protect his or her interests in selecting or using a consumer financial product or service, or his reasonable reliance on the covered person to act in his or her interests.

Although abusive acts or practices may also be unfair or deceptive, each of these prohibitions are separate and distinct, and are governed by separate legal standards, as set forth in the CFPB Exam Manual. The bulletin includes a non-exhaustive list of examples of unfair, deceptive and/or abusive acts or practices which may occur in the collection of consumer debts.

Of interest to mortgage servicers and other creditors, examples of such practices expressly include, among others, collecting or assessing amounts in connection with a debt (including interest, fees, and charges) not expressly authorized by the agreement creating the debt or otherwise permitted by law, and failing to post payments timely or properly or to credit a consumer's account with payments that the consumer submitted on time and then charging late fees to that consumer.

Indirect Auto Lending Industry Targeted by CFPB

BY ELIZABETH BOHN

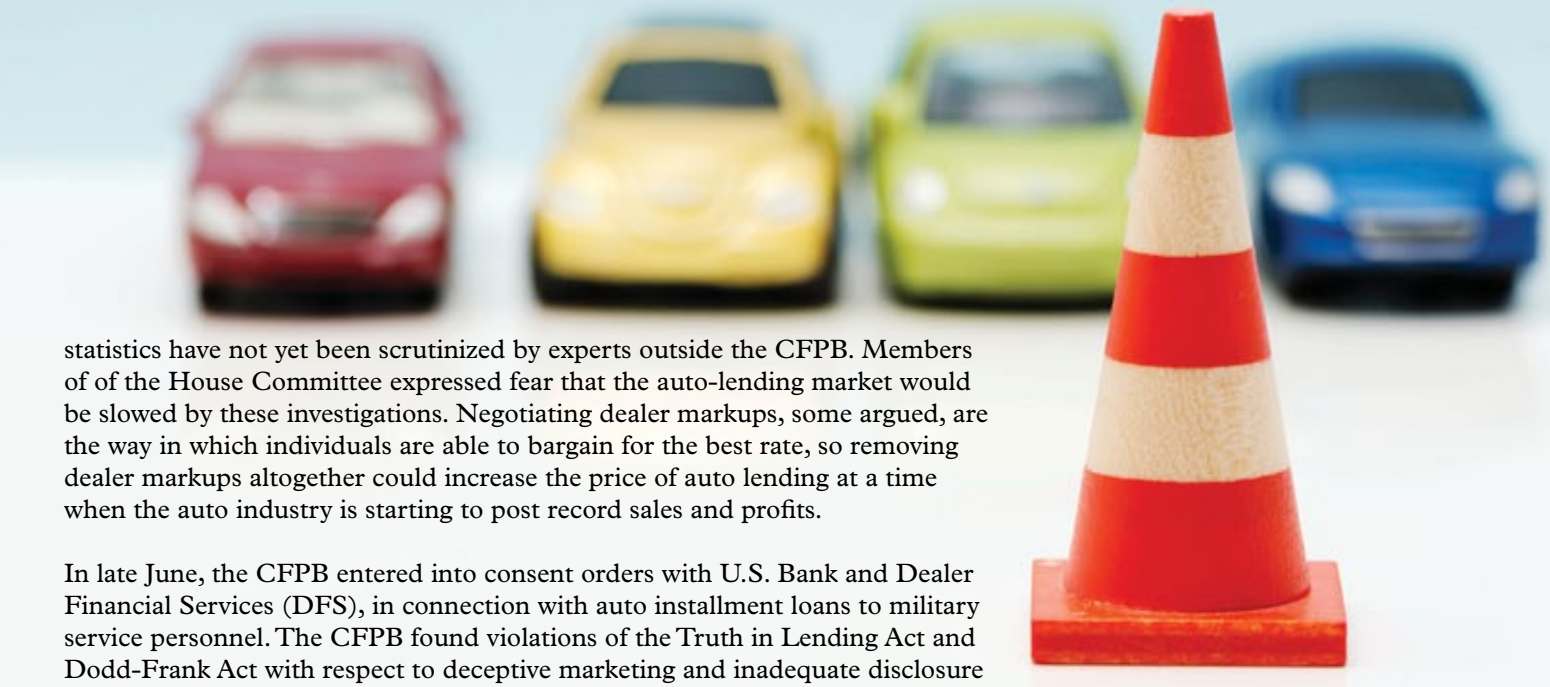
While auto dealers won a hard-fought exemption from the Dodd-Frank Act, recent investigations and enforcement actions by the Consumer Financial Protection Bureau (CFPB) reflect its position that the auto finance industry remains subject to its jurisdiction.

In late March, the CFPB issued guidance to indirect auto lenders regarding compliance with the Equal Credit Opportunity Act. The premise of the issuance was that racial minorities were being disparately affected in loan interest rates indicative of violations of the ECOA. While the CFPB has no direct jurisdiction over auto dealers under the Dodd-Frank Act, Department of Justice officials stated that the DOJ was partnering with the CFPB to investigate alleged discriminatory rate structures in auto lending, reflecting a widespread probe.

Even before the passage of the Dodd-Frank Act and the creation of the CFPB, DOJ had entered into consent orders with prominent auto dealers across the country under the ECOA in 2007-2010, which capped those dealer markups and required the dealers to establish firm guidelines and practices for negotiating auto loan interest rates. The dealers also agreed to a management loan review process to ensure compliance with the policies, and the the DOJ reserved the right to inspect all documentation regarding loans originated by these dealers throughout the term of the consent orders.

In response to the announcement that the CFPB and the DOJ would partner to investigate disparate impacts caused by dealer markups, **many of the nation's largest banks announced that they would be reevaluating policies regarding dealer markups, with some saying that the practice may be eliminated altogether.**

On the other hand, the House Financial Services Committee requested more information on the shift in policy in late spring, expressing dissatisfaction that enforcement actions could begin without any hearings, comments, or statistics explaining the policy change. While the CFPB is relying on statistics that it claims show a disparate impact negatively affecting racial minorities, these



statistics have not yet been scrutinized by experts outside the CFPB. Members of of the House Committee expressed fear that the auto-lending market would be slowed by these investigations. Negotiating dealer markups, some argued, are the way in which individuals are able to bargain for the best rate, so removing dealer markups altogether could increase the price of auto lending at a time when the auto industry is starting to post record sales and profits.

In late June, the CFPB entered into consent orders with U.S. Bank and Dealer Financial Services (DFS), in connection with auto installment loans to military service personnel. The CFPB found violations of the Truth in Lending Act and Dodd-Frank Act with respect to deceptive marketing and inadequate disclosure of product information to military service personnel. U.S. Bank and DFS agreed to return a minimum of $6.5 million dollars to the more than 110,000 service members that had utilized their joint program. This is in addition to being required to improve their disclosures, to discontinue the ability of costumers to use military allotments, and to fundamentally change the marketing and lending practice of their military installment loan program.

The CFPB is thus taking serious aim at indirect auto-lending. It is expected that it may issue regulations directly impacting the industry in 2014.

Supreme Court is making it harder for those hoping to escape arbitration provisions.

Courts Must "Rigorously Enforce" Arbitration Agreements

BY LANDON CLAYMAN

In another of a string of pro-arbitration decisions in recent years, the U.S. Supreme Court in *American Express Co. v. Italian Colors Restaurant* narrowed an escape hatch for those seeking to elude their contractual duty to arbitrate a dispute. *Italian Colors* involved federal antitrust claims brought as a class action by merchants that accept American Express cards for customer purchases. The plaintiffs sought to avoid their arbitration agreements to individually arbitrate disputes with AmEx by seizing upon the "effective vindication" theory, which is based upon a dictum in the *Mitsubishi Motors* case indicating the Court might invalidate an arbitration agreement on "public policy" grounds if it operated as a "prospective waiver" of the "right to pursue statutory remedies." The *Italian Colors* plaintiffs asked the courts to invalidate their arbitration agreements because it would be prohibitively expensive and economically irrational to individually arbitrate their antitrust claims. The only way to "effectively vindicate" those claims, they argued, was to be permitted to proceed on a class action basis.

The Supreme Court reversed the Second Circuit's decision that the class action waiver in the arbitration agreements was unenforceable. **The Court distinguished the "expense involved in *proving* a statutory remedy" from the "*right to pursue* that remedy[,]" noting that the class action waiver did not eliminate the plaintiffs' rights to pursue their statutory remedies; it only limited arbitration to the two contracting parties.** The Court explained that simply because "it is not worth the expense involved in *proving* a statutory remedy does not constitute the elimination of the *right to pursue* that remedy."

The *Italian Colors* decision limits the "effective vindication" theory for avoiding arbitration agreements to situations in which the agreements forbid the "assertion of certain statutory rights," and possibly situations in which "filing and administrative fees" associated with arbitration "are so high as to make access to the forum impracticable."

ARBITRATION ROUNDUP

BY LANDON CLAYMAN

The U.S. Supreme Court's decision in *Oxford Health Plans LLC v. Sutter* highlights the risk of agreeing to allow an arbitrator instead of a court to decide whether an arbitration agreement permits class arbitration. In *Sutter*, the arbitration agreement was silent on the question of class arbitration, but the parties agreed the arbitrator should decide whether it permitted class arbitration. When the arbitrator ruled, even following the *Stolt-Nielsen* decision, that the agreement permitted class arbitration, the defendant sought judicial review.

Affirming the Third Circuit's decision to allow the arbitrator's ruling to stand, the Supreme Court emphasized the limited review of arbitrators' decisions allowed under the Federal Arbitration Act. Because the arbitrator in *Sutter* had purported to interpret the parties' contract, his decision could not be set aside regardless of whether it was wrong. To try to avoid such situations, parties might consider stating expressly and clearly in their arbitration agreements whether class arbitration is permitted.

Cybersecurity: Are Insurers Potentially at Risk from Hackers and Government Oversight?

BY JASON MORRIS & WHITNEY FORE

On May 28, 2013, in keeping with recent efforts to beef up the state government's role in cybersecurity, the New York Department of Financial Services (DFS) sent "308 letters" to the largest insurance companies that DFS regulates with regards to the insurers' cybersecurity measures. These letters required insurers to respond with the following:

- Information on any cyber attacks to which the company has been subject in the past three years;
- the company's information technology management policies;
- the amount of money and other resources dedicated to cybersecurity at the company;
- the company's governance and internal control policies; and
- cybersecurity safeguards put in place by the company.

The DFS has not stated what it will do with the information contained in the insurers' responses to the 308 letters. Therefore, **insurers may rightfully be concerned that their sensitive, confidential information will be used in ways that could adversely affect them and their customers**.

The DFS's investigation into insurers comes hot off the heels of other inquiries made by the Department to similarly ensure that New York's banking giants are taking strides to protect their customers' cyber data.

On a related note, New York Governor Andrew Cuomo has recently established a state cybersecurity board that will advise and make recommendations to his administration with regards to cybersecurity developments. In justification of actions taken by both the DFS and the newly-minted Cyber Security Advisory Board, Governor Cuomo has said, "Recent reports of cyber-attacks on governments and corporations are further evidence that our physical and virtual worlds are increasingly intertwined and the need to increase cybersecurity to guard against these threats is urgent."

Business Methods: Patent Eligible Or Not?

BY ABIGAIL KORTZ & DIANE DUHAIME

Sitting *en banc*, the Federal Circuit recently attempted to clarify the standard for patent eligibility under Section 101 of the Patent Act and, more specifically, its application to business method patents in *CLS Bank International v. Alice Corporation Pty. Ltd.* The attempt fell short of its goal, resulting in five different opinions, none of which amounts to a majority. The business method at issue in the case uses a computerized trading platform and a third party to eliminate certain risk in financial transactions. Five of the ten judges held that all of the business method claims at issue are not patent eligible because their subject matter falls into a judicially-created exception to Section 101 for "abstract ideas." Three judges held that all of the claims are patent eligible, and two of the judges, including the Chief Judge, held that some of the claims are patent eligible while others are not. **Each of the five different opinions also proposes different standards for determining patent eligibility under Section 101, providing little guidance to follow in determining *inter alia* whether and how to pursue patents for business methods.**

With the Federal Circuit in a "judicial deadlock," the Supreme Court may need to revisit the standard for patent eligibility, having done so as recently as 2012 in *Mayo Collaborative Services v. Prometheus Laboratories, Inc.* and 2010 in *Bilski v. Kappos*. In both of those cases, the Supreme Court held that the methods at issue were not patent eligible. It has not always been the case that so much uncertainty has surrounded the patent eligibility of business method patents. In 1999, the Federal Circuit held in *State Street Bank & Trust Co. v. Signature Financial Group, Inc.* that business methods are patent eligible.

Congress has also taken an interest in business method patents, having recently introduced a bill, the Stopping the Offensive Use of Patents Act, which expands the "transitional program for covered business method patents" from just business method patents for financial products to all business method patents and eliminates the 2020 expiration date for the program. The transitional program makes it easier for defendants to invalidate business method patents by requesting a review at the U.S. Patent and Trademark Office, rather than having to challenge a patent's validity in federal court. Given these recent developments, the future of business method patents may not be so bright.

NEWS & NOTES

JORDEN BURT®

JORDEN BURT PARTNER **JIM JORDEN** SPOKE AT THE AMERICAN CONFERENCE INSTITUTE'S CONFERENCE ON LIFE INSURANCE AND AD&D CLAIMS AND LITIGATION JULY 29–30, 2013 IN NEW YORK, NY.

DC OF COUNSEL, **GARY COHEN'S** ARTICLE, "SEC AND STATE REGULATION OF INDEXED INSURANCE PRODUCTS: THE PLOT THICKENS," WAS PUBLISHED IN THE AUGUST 2013 ISSUE OF THE INVESTMENT LAWYER.

MIAMI PARTNER, **SONIA O'DONNELL** WAS RE-APPOINTED AS CO-CHAIR OF THE APPELLATE PRACTICE COMMITTEE OF THE ABA'S SECTION OF LITIGATION FOR THE 2013–14 YEAR.

MIAMI PARTNER, **ELIZABETH BOHN** PRESENTED "KEY ISSUES IN THE TREATMENT OF THE SOLAR LESSOR'S CLAIM IN THE LESSEE'S BANKRUPTCY" AT THE AMERICAN BAR ASSOCIATION'S ANNUAL MEETING AUGUST 10, 2013 IN SAN FRANCISCO.

JOAN BOROS, OF COUNSEL IN THE WASHINGTON, DC OFFICE SPOKE IN JUNE ON "LEGAL ISSUES AND ANNUITIES" AT THE NATIONAL ASSOCIATION OF FIXED ANNUITY 2013 ANNUITY LEADERSHIP FORUM IN ARLINGTON, VA.

THE 18TH ANNUAL ALI-CLE CONFERENCE ON LIFE INSURANCE AND FINANCIAL SERVICES LITIGATION WILL TAKE PLACE DECEMBER 5, 2013 IN WASHINGTON, DC. **JIM JORDEN** IS A CO-CHAIR AND **JULIE MCCABE**, PARTNER IN THE MIAMI OFFICE, IS ON THE FACULTY. THE CONFERENCE WILL FEATURE A HYPOTHETICAL CASE AND MOCK TRIAL. FOR MORE INFORMATION AND TO REGISTER, VISIT WWW.ALI-CLE.ORG.

JORDEN BURT LLP is a national legal boutique providing litigation services and counseling to the financial services sector. The firm serves clients in seven key industries:


Life Insurance


Securities

Reinsurance

Consumer Finance & Banking


Property & Casualty Insurance

Investment Companies & Advisers


Health Care

For more information, visit our website at www.jordenburt.com.

JORDEN BURT®

SOUTHEAST
Suite 500
777 Brickell Avenue
Miami, FL 33131–2803
305.371.2600
Fax: 305.372.9928

WASHINGTON, D.C.
Suite 400 East
1025 Thomas Jefferson St., N.W.
Washington, D.C. 20007–5208
202.965.8100
Fax: 202.965.8104

NORTHEAST
Suite 301
175 Powder Forest Drive
Simsbury, CT 06089–9658
860.392.5000
Fax: 860.392.5058