LIFE, ANNUITY, AND RETIREMENT SOLUTIONS INDUSTRY

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EXPECTFOCUS®

LEGAL ISSUES AND DEVELOPMENTS FROM CARLTON FIELDS

RESETTING THE RULES

A FAST START FOR THE NEW DECADE

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EXPECTFOCUS®

LIFE, ANNUITY, AND RETIREMENT SOLUTIONS DECEMBER 2019

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

Innovation and Technology at the NAIC 2019 Fall Meeting

BY ANN BLACK AND JAMIE BIGAYER

Several NAIC groups continued addressing issues related to innovation in the life insurance industry as follows:

- **PRIVACY PROTECTIONS WORKING GROUP** – is determining whether the NAIC Insurance Information and Privacy Protection Model Act (#670) and the Privacy of Consumer Financial and Health Information Regulation (#672) need to be revised, as a result of the increased use of consumer data, to address any gaps in the current regulatory framework. Initially, the group compared the existing NAIC models against the California Consumer Privacy Act as an example. It also discussed insurers' reliance on third parties and the insurers' responsibility to ensure that third parties comply with applicable laws and use accurate data in their determinations.

- **ACCELERATED UNDERWRITING WORKING GROUP** – is obtaining information on, and is assessing issues that may arise out of, life insurers' use of accelerated underwriting. It will evaluate the issues and determine whether it should draft guidance for the states.

- **ARTIFICIAL INTELLIGENCE WORKING GROUP** – is drafting guiding principles for the use of artificial intelligence in insurance for use by the various NAIC groups, state regulators, and the insurance industry. The draft principles, which are based on the OECD Principles on Artificial Intelligence that seek to promote innovation while protecting privacy and transparency and preventing discrimination, are being tailored for the insurance industry.

- **BIG DATA WORKING GROUP** – concluded that regulators have adequate authority under existing insurance laws and regulations to review insurers' use of data and algorithms, including as provided by third-party vendors. It discussed whether third-party vendors should be subject to regulatory authority through FCRA-like regulation or requiring that third-party vendors be licensed as advisory organizations.

FSOC: "Too Big to Fail" Has Failed

Insurance and Investment Firms Breathe Easier

BY TOM LAUERMAN

On December 4, 2019, the Financial Stability Oversight Council adopted final interpretive guidance on addressing systemic threats to the financial system that prioritizes the identification and regulation of risky "activities" rather than risky companies.

Pursuant to the Dodd-Frank Act, the FSOC initially adopted standards for designating systemically important nonbank financial institutions (SIFIs) that relied heavily on the size of the institution, among other considerations. SIFIs — often referred to as "too big to fail" — are deemed to expose the U.S. financial system to such significant risks that, under Dodd-Frank, they are subjected to special prudential regulation by the Federal Reserve Board.

Following Dodd-Frank's enactment, very large insurance, mutual fund, and money management firms (among others) were concerned that they might be designated as SIFIs, and several large insurance companies did in fact receive such designations. The prudential regulation to which these insurance companies were subjected proved burdensome and arguably unnecessary, given the nature of their activities and the state insurance and other regulation to which they already were subject.

Based on such considerations, the FSOC has, for a number of years, been placing more emphasis on (a) identifying activities that pose significant risks to the financial system and (b) appropriately addressing such risks across a spectrum of different-sized companies engaged in those activities, rather than seeking to assign the SIFI label to individual companies that, by themselves, pose systemic risks. The FSOC's December 4 final interpretive guidance is the most recent and definitive articulation of this approach.

Under the final interpretive guidance, the FSOC will, among other things, give priority to identifying activities that present systemic risks and seeking to adequately control those risks by making nonbinding recommendations to the primary regulators of the companies engaged in those activities. It is hoped that an institution's primary regulators — e.g., state insurance regulators, the SEC, the CFTC, etc. — will be better able than the Federal Reserve Board to tailor appropriate constraints on that institution's risky activities.

For that and other reasons, insurance companies and money managers have generally welcomed the FSOC's migration away from "too big to fail" that has now culminated in the final interpretive guidance; and the FSOC has not recently designated any such firms as SIFIs. Nevertheless, if the FSOC does not believe that measures imposed by an institution's primary regulators can or do adequately address systemic risks presented by that institution, the FSOC and the Federal Reserve Board still retain a variety of other remedial options, including, in appropriate cases, designating and regulating the institution as a SIFI.

Round and Round – Will 2020 Bring the End to Inconsistent Anti-Rebating Prohibitions?

BY ANN BLACK AND JAMIE BIGAYER

Since mid-2018, the NAIC's Innovation and Technology (EX) Task Force (Innovation TF) has been considering how state anti-rebating laws impede insurers and producers' ability to offer innovative products and services to insureds. Innovation TF members sought to develop guidance or bulletins that would permit insurers and producers to provide "value-added" products and services. During 2019, the Innovation TF worked on language for a template bulletin as a potential alternative to revising the NAIC's model Unfair Trade Practices Act (Model #880).

The Innovation TF initially worked on draft guidance that would allow for value-added products and services to be offered to consumers. However, as the Innovation TF went round and round in the drafting process, it discovered that the interpretation and implementation of Model 880 was inconsistent among the several states. Adding to the complexity, while the Innovation TF worked on the draft bulletin, Alabama, Arizona, Connecticut, Florida, Massachusetts, Missouri, New Hampshire, New York, North Dakota, Ohio, Pennsylvania, South Carolina, Washington, and West Virginia have either proposed or adopted new legislation, rules, or bulletins addressing their states' anti-rebating prohibition.

While most of the new or proposed provisions would permit products or services that "mitigate," "minimize," or "assess" the insured "risk" or "loss," some states provided for additional products or services such as "education" or "servicing." In addition, some states imposed additional requirements. For example, Alabama also requires that the insurer be able to discontinue the service at any time. West Virginia requires the product or services to be "clearly identified and included in the policy."

As a result of the variations, the Innovation TF agreed at the NAIC's Fall National Meeting to abandon work on a template bulletin. Rather, to obtain more consistency across the states, the Innovation TF decided to draft Model 880 language to allow for providing value-added products and services. In 2020, a small drafting group will review draft language submitted by the American Property Casualty Insurance Association and comments and presentations received during 2019 and work on language for Model 880.

To increase the likelihood of uniformity among the states, the drafting group would also need to consider the Rebate Reform Model Act developed by the Financial Services and Multi-Lines Issues Committee of the National Council of Insurance Legislators. Hopefully, the Innovation TF will be able to develop revisions to Model 880 during 2020 that will be quickly adopted by the states to end inconsistent anti-rebating prohibitions.

Insurance Company High-Yield Real Estate Investments

The Value Outside Counsel Can Contribute

BY FRANK APPICELLI

The insurance industry has played a significant role in the commercial real estate (CRE) market for more than a century. A major part of CRE investments for insurance companies has been commercial mortgage loans, traditionally consisting of first-lien, low-leveraged loans for stable properties. Before the 2008 downturn, insurance companies expanded into mezzanine financing, "B" notes, and junior loan participations. However, after 2008, many insurance companies pulled back from such nontraditional investments and returned to their roots in low-leveraged first-lien mortgage loans.

The last 10 years has been a period of unprecedented low interest rates. While the CRE market has not been immune to this, CRE investments have provided an opportunity to achieve higher yields than other sectors. During this same period, real estate values have rebounded to their pre-2008 heights. These factors have made the CRE lending market more attractive to insurance companies and have led to increased investment portfolio allocations to CRE. However, these same factors have also led to increased competition in the CRE lending market with CMBS loan originators, government agencies, commercial banks, and debt funds.

In the face of this continuing low interest rate environment, more money to invest, and greater competition to win deals, insurance companies have searched for higher-yielding debt investments in less crowded areas. These investments have taken the form of:

- Mezzanine and other high-yield structured financings
- "Participating" mortgage loans (i.e., loans with returns tied to asset appreciation or cash flow)
- Construction loans
- "B" notes
- Junior loan participations
- Preferred equity (sometimes with features resembling debt)
- Joint ventures

Having been active in the CRE market for more than 25 years, we have witnessed close hand the changes in the investment activity of our insurance company clients. With many clients having retreated from riskier and higher-yielding CRE investments 10 years ago, it is not a simple process for them to pivot back into this area for a number of reasons. First, in-house professional knowledge and experience have dwindled as investment and legal professionals moved into other areas or retired. Second, the legal and market considerations for these investments have changed considerably in the last decade, which makes earlier institutional knowledge stale. Third, by their very nature higher-yielding investments carry more risk and thus require careful underwriting and execution. Despite these challenges, many insurance companies have been venturing back into the high-yield CRE investment market.

In conventional CRE mortgages, low leverage with a hefty equity cushion can provide a comfortable degree of protection against risks, such as unexpected environmental or property condition deficiencies or a sluggish leasing market. However, in higher-yielding and higher-risk investments, the insurance company may be an equity investor or a junior debt holder, all much closer to the first-loss position.

Outside legal counsel can provide substantial value to insurance companies in addressing the challenges of high-yield CRE investing, especially in the following areas:

- **Finance and equity transactional expertise** – the legal documents will still comprise the backbone of the transaction. Expertise in collateral, intercreditor, and other documentation issues is essential.

- **Environmental** – a solid and practical understanding of environmental issues remains an important specialty in both conventional mortgage loans and high-yield investments.
- **Tax** – while not an issue in debt transactions, tax counsel is critical in private equity and joint venture transactions.
- **Construction** – construction expertise is a must-have skill in construction loans and equity investments involving new construction or redevelopment.
- **Leasing** – knowledgeable leasing counsel is desirable in equity investments in which the investor is closer to operational matters.
- **Creditors' rights and litigation** – while no institution enters an investment expecting it to fail, one must always be prepared for that possibility in high-yield riskier investments.

In our experience, it is highly desirable that outside counsel for a high-yield investment platform provide a multidisciplinary team of lawyers who can address the various legal areas involved in such investments. As one of the few firms that offer an integrated team of such lawyers who represent insurance companies in the full spectrum of CRE transactions, we will continue to report on issues and developments in this area.

OCIE Risk Alert Highlights Compliance Program Catch-22

BY TOM LAUERMAN

A risk alert issued on November 7, 2019, by the SEC's Office of Compliance Inspections and Examinations underscores a continuing dilemma faced by SEC-regulated entities.

The risk alert undertakes to summarize the "most often cited deficiencies and weaknesses that the staff has observed in recent examinations of registered investment companies." Many of the summarized deficiencies involve failures to adhere to the various types of compliance policies and procedures that the registrants have adopted — even in cases in which the failure did not result in whatever type of legal violation the procedures might have been designed to prevent.

OCIE's tendency to cite failure to adhere to compliance policies and procedures as a discrete compliance deficiency naturally incentivizes registrants to limit the scope and detail of their compliance policies and procedures as much as possible, consistent with being reasonably designed to prevent violations of relevant legal requirements.

However, attempts to pare back on any arguably superfluous compliance policy and procedure provisions also risk incurring OCIE's ire. Indeed, the preponderance of the risk alert summarizes numerous areas in which the staff seems ready to second-guess registrant judgments that more detail is unnecessary in compliance policies and procedures, even if no other legal violation has resulted.

It can be appropriate for some compliance policies and procedures to be quite general in nature — e.g., simply assigning to a particular person responsibility for compliance with a given legal requirement, perhaps specifying some key principles for that person to follow. To ensure compliance with other legal requirements, however, it may be necessary or advisable to adopt a more prescriptive approach that specifies in some detail what steps the responsible personnel are to take.

The process of crafting compliance policies and procedures, therefore, necessarily involves difficult judgment calls, and the Risk Alert makes clear that registrants will not be immune from OCIE criticism after the fact, regardless of what approach they take. This doubtless also applies to registered broker-dealers and investment advisers, although the risk alert by its terms only covers mutual funds, insurance company separate accounts, and other registered investment companies.

NAIC Life Insurance and Annuities (A) Committee Ends 2019 With a Big Bang

BY ANN BLACK AND JAMIE BIGAYER

On December 30, 2019, the Life Insurance and Annuities (A) Committee approved a revised Suitability in Annuity Transactions Model Regulation (Revised Suitability Model), ending a flurry of activity over the past year. The Revised Suitability Model must be approved by all voting members of the NAIC and then adopted by individual states before it will apply to annuity transactions. Commissioner Ommen, chair of the committee, explained that the Revised Suitability Model aligns the state standard of conduct with the SEC's Regulation Best Interest and provides more than suitability **but does not** impose a fiduciary standard.

In with the new year is a best interest standard of care that comprises four components:

- Care Obligation
- Disclosure Obligation
- Conflict of Interest Obligation
- Documentation Obligation

Invited to the gala are all producers who have "exercised material control or influence in the making of a recommendation and ha[ve] received direct compensation as a result of the recommendation or sale, regardless of whether the producer has had any direct contact with the consumer." These producers are subject to the Revised Suitability Model requirements, in recognition that a producer with the consumer relationship may consult with another producer who provides the recommendation.

The Revised Suitability Model enhances the requirement that insurers establish and maintain a supervision system reasonably designed to achieve compliance with the Revised Suitability Model. It also invites other "comparable standards" as safe harbors that are deemed to satisfy the requirements of the Revised Suitability Model.

Below is a summary of the four component obligations, the insurers' supervision requirement, the safe harbor, and certain notable items.

Care Obligation

The Care Obligation requires four acts, exercised with reasonable diligence, care, and skill, as follows:

1. **Know** the consumer's financial situation, insurance needs, and financial objectives;
2. **Understand** the available recommendation options after making a reasonable inquiry into available options;
3. Have a **reasonable basis to believe** the recommended option effectively addresses the consumer's financial situation, insurance needs, and financial objectives over the life of the product, as evaluated in light of the consumer profile information; and
4. **Communicate** the basis or bases of the recommendation.

The Care Obligation contains 10 additional provisions explaining what is, and what is not, required to satisfy these four acts. In general, the producer must consider the totality of the consumer's information — which the producer has made reasonable efforts to obtain — against the totality of the products available to be sold by the producer, and must conclude that the annuity effectively addresses the consumer's financial situation, insurance needs, and financial objectives, and that the consumer would benefit from certain features of the annuity.

Items of Note:

- The importance of the factors relevant in determining whether an annuity effectively addresses a consumer's financial situation may vary based on the facts and circumstances of a particular case.
- The recommendation does not have to be the annuity with the lowest one-time or multiple occurrence compensation structure.

Disclosure Obligation

The Disclosure Obligation sets forth three disclosure requirements:

1. Prior to any recommendation, an "Insurance Agent (Producer) Disclosure for Annuities" form setting forth:
   - The scope and terms of the producer's relationship with the consumer and the producer's role in the transaction.
   - The products the producer is licensed and authorized to sell.
   - The insurers for whom the producer may sell products.
   - The sources and types of cash and non-cash compensation to be received by the producer and from whom the producer will receive the compensation.
   - Notice of the consumer's right to request more information on the cash compensation to be received.
2. If requested by the consumer or the consumer's designated representative, a reasonable estimate of the cash compensation to be received and whether the compensation amount is a one-time or multiple occurrence amount.
3. Prior to or at the time of the recommendation, disclosure of the various features of the annuity.

Items of Note:

- The Insurance Agent (Producer) Disclosure must be provided at the outset of the relationship so the consumer can decide whether to provide his or her information.
- To ensure the consumer receives the disclosure, the signature page should not appear on a separate page.

Conflict of Interest Obligation

The Conflict of Interest Obligation requires a producer to:

1. identify, and
2. either:
   a. avoid, or
   b. reasonably manage and disclose

material conflicts of interest, including material conflicts of interest related to an ownership interest.

In addition, as part of the Best Interest Obligation, in making a recommendation, a producer must act without placing the producer's or the insurer's financial interest ahead of the consumer's interest.

Items of Note:

- "Material conflict of interest" means a financial interest of the producer in the sale of an annuity that a reasonable person would expect to influence the impartiality of a recommendation, but does not **include** cash compensation or non-cash compensation.
- Insurers are required to eliminate sales contests, sales quotas, and bonuses that are **based on the sales of specific annuities within a limited period of time.**

Documentation Obligation

The Documentation Obligation varies, as follows:

- If a recommendation was made – the producer must make a written record of any recommendation and the basis for the recommendation.
- If the consumer refused to provide some or all of the consumer's information – a signed "Consumer Refusal to Provide Information" form at the time of the sale.
- If the consumer purchased an annuity that was not recommended – a signed "Consumer Decision to Purchase an Annuity NOT Based on a Recommendation" form at the time of the sale.

Items of Note:

- Even if a transaction is not based on a recommendation, an insurer's issuance of the annuity must be reasonable under all circumstances actually known to the insurer at the time the annuity is issued.
- Insurers must establish and maintain reasonable procedures to identify and address suspicious consumer refusals to provide consumer profile information.

Insurer Supervision

The insurer supervision requirements were enhanced by requiring insurers to establish and maintain reasonable procedures in three additional areas:

1. To assess whether a producer has provided to the consumer the information required by the Revised Suitability Model.
2. To identify and address suspicious consumer refusals to provide consumer profile information.
3. To identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific annuities within a limited period of time.

The Revised Suitability Model also makes clear that the insurer's system of supervision does not need to include a "comparison to options available to the producer or compensation relating to those options other than annuities or other products offered by the insurer."

Safe Harbor

Under the Revised Suitability Model, the safe harbor was expanded beyond compliance with FINRA's suitability and supervision requirements. The safe harbor applies to "all recommendations and sales of annuities made by financial professionals in compliance with business rules, controls and procedures that satisfy a comparable standard even if such standard would not otherwise apply to the product or recommendation at issue." The financial professionals that fall within the safe harbor are:

- A registered broker-dealer or a registered representative of a broker-dealer;
- A registered investment adviser or an investment adviser representative associated with the registered investment adviser; or
- Specified plan fiduciaries under the Employee Retirement Income Security Act of 1974 or the Internal Revenue Code.

The Revised Suitability Model notes that each state must determine whether to extend the safe harbor to state-registered broker-dealers and investment advisers.

While the safe harbor applies, an insurer is still obligated not to issue an annuity unless there is a reasonable basis to believe the annuity would effectively address the particular consumer's financial situation, insurance needs, and financial objectives. The NAIC Executive Committee and Plenary will consider the adoption of the Revised Suitability Model on February 13, 2020.

Now that the festivities are complete, it is time for insurers to start considering their New Year's resolutions to modify their existing policies and procedures for the new requirements of the Revised Suitability Model.

Life Insurance That Benefits the Living

BY ANN BLACK AND MEGAN DHILLON

For decades, life insurance has been viewed as just providing benefits to those named as the beneficiary. As we enter the new decade, insurers are changing this narrative. Insurers are looking to offer insureds a range of value-added products and services with the life insurance products as well as benefit riders that permit insureds to receive part of the death benefit or take loans from their policies allowing them to use the proceeds to improve their life.

Insurers are developing programs under which insureds are given access to health care apps, devices, such as smartwatches or smart speakers, and telemedicine services, which allow beneficiaries to manage chronic medical conditions, track their medication, be more active, and maintain healthy lifestyles. However, while these products and services can be valuable to both insurers and insureds, life insurers have to consider several legal issues when structuring these programs.

- Will the value-added product or service run afoul of state anti-rebating prohibitions?
- Do your partners have appropriate safeguards and policies to protect the insureds' information?

To the extent that access to health providers is made available, these programs may involve the provision of health care services. Thus, a life insurer must consider whether the value-added services are viewed as a form of health insurance under state law. States vary in their definitions of health insurance, but a policy that provides medical benefits in exchange for a premium could be considered health insurance. Life insurance companies would then need to comply with the requirements pertaining to health insurers. Those additional requirements would add numerous regulatory challenges and burdens for life insurers.

However, to avoid classification as a health insurer, life insurance companies can structure health services programs under statutory protections afforded to concierge medicine practices. Concierge medicine practices, which allow patients to directly contract with health care practitioners for the provision of health care services in exchange for an annual or periodic fee, are specifically exempt from the definition of health insurance in numerous states.

SEC Pressures Advisers on Undisclosed Conflicts

BY EDMUND ZAHAREWICZ

'We are actively looking for circumstances where an adviser is financially conflicted by incentives that could affect investment recommendations to clients. ... And I will tell you: the more we look, the more undisclosed or inadequately disclosed financial conflicts we find."

Those ominous words were part of SEC Division of Enforcement Co-Director Stephanie Avakian's keynote remarks at a November securities regulation conference. While her remarks focused on the investment advisory space, Avakian made clear that the division's interest in identifying and addressing undisclosed conflicts applies "across the securities markets."

Share Class Self-Reporting Initiative

As an example of the type of conflicts she was talking about, Avakian referred to the division's recent share class selection disclosure self-reporting initiative, which was designed to identify and address harm resulting from undisclosed conflicts of interest in the selection of mutual fund shares by investment advisers. The initiative resulted in 95 enforcement actions against firms that had the choice of investing their clients' money in different classes of the same investment and chose the more expensive option without fully disclosing that this option paid the firm additional compensation. These settled actions ordered the return of more than $135 million to investors and required that the advisers' practices be reflected in their disclosures to clients.

While these actions represent a small fraction of the overall registered adviser population, Avakian's remarks also suggest that at least some advisers were able to avoid the types of disclosure failures seen in these cases by having fulsome disclosure, choosing not to take 12b-1 fees, rebating fees or crediting fees back to clients, or recommending the lower-cost share class.

If the division is truly discovering widespread deficiencies in conflicts disclosures, as Avakian's remarks seem to suggest, it would not be surprising to see the division launch additional self-reporting initiatives like the share class selection initiative.

Other Types of Conflicts in SEC Crosshairs

According to Avakian, the division is also actively looking for and finding undisclosed conflicts in other areas. These include:

- Revenue-sharing arrangements in which a clearing broker pays a portion of the fees it charges mutual funds for access to its platform to (a) an investment adviser that is also registered as a broker-dealer (a "dually registered adviser") or (b) an adviser's affiliated introducing broker-dealer.
- Cash sweep arrangements in which a dually registered adviser or an adviser's affiliated broker-dealer may receive additional compensation for recommending one cash investment over another.
- Bank deposit cash sweep programs in which a bank or the bank's affiliated clearing broker pays a portion of the revenue the bank earns on investor deposits to a dually registered adviser or an adviser's affiliated broker-dealer.

- Unit investment trusts that are sold with one fee structure for broker-dealer customers and another for investors who will hold the UIT in a fee-based advisory account, where a dually registered adviser or an adviser's affiliated broker-dealer may generate more revenue by recommending UIT interests with one fee structure over the other.

Section 403(b) Plan Initiative

Avakian also noted that, as part of an agencywide initiative, the division is looking at the administration of teacher retirement plans (i.e., "403(b) plans") as another area in which there may be undisclosed conflicts. In particular, as has been widely reported, the division is looking at the compensation and sales practices of the plans' third-party administrators, as well as the practices of their affiliated advisers and broker-dealers.

Avakian was careful to specify certain things the division is not doing. In particular, she made clear that the division is not making value judgments on financial incentives, the scope of services provided, or the fees charged to investors. Rather, the division is looking only at issues that "may directly affect an investor's return on an investment."

FAQ on Adviser Compensation Disclosure

Avakian's remarks followed by several weeks — and beat the same drum as — "Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation" published by the staff of the Division of Investment Management. The FAQ represent the staff's view regarding the disclosure obligations of advisers with respect to conflicts of interest that result when an adviser receives compensation, directly or indirectly, in connection with the investments the adviser recommends.

Among other things, the FAQ remind advisers of their general disclosure obligations and the specific disclosure requirements in Form ADV. When such a conflict exists, for example, an adviser must disclose how the adviser addresses the conflict and include in the adviser's disclosure "sufficiently specific facts" to allow clients to understand the conflict and the adviser's business practices and give informed consent or reject them. An adviser's fiduciary duty may also require the adviser to make disclosures to clients that are in addition to those required in Form ADV.

Elimination or Mitigation of Conflicts

The SEC staff's current aggressive initiative against undisclosed conflicts, coupled with the staff's public articulation of the fiduciary standards and specific requirements that conflicts disclosures must meet, may push advisers to favor business models that eliminate, or at least mitigate, conflicts over models that rely on the disclosure of conflicts alone. Indeed, the SEC staff may be seeking that result, as it would tend to harmonize the practices of investment advisers with those of broker-dealers under Regulation Best Interest, which is now looming on the horizon.

In contrast to advisers, broker-dealers recommending securities transactions will be required by Reg BI to adopt business models that eliminate or at a minimum mitigate specified types of conflicts, and dually registered advisers may be hard pressed not to operate under the higher Reg BI standard. As for other advisers, it remains to be seen what impact Reg BI and the current spotlight on undisclosed conflicts will have on their business practices going forward. What is certain, however, is that advisers and broker-dealers should be proactive in evaluating potential conflicts and assessing disclosures in light of their current practices and changing regulatory and business landscapes.

Reg BI Compliance Countdown: T-Minus Six Months

BY ANN FURMAN

As the June 30, 2020, compliance date approaches, broker-dealers are taking steps to implement Regulation Best Interest (Reg BI), which establishes a new standard of conduct when making recommendations to retail customers of any securities transaction or investment strategy involving securities. The new rule requires additional disclosures, policies and procedures, conflict identification, and training beyond what broker-dealers have previously had in place.

Reg BI compliance steps specifically include: identifying potential conflicts of interest; assessing reasonably available alternative recommendations; reviewing, revising, and adding conflict disclosure; drafting a relationship summary (on new Form CRS); amending and developing supervisory procedures to identify and address conflicts of interest; and training associated persons to assure that each recommendation they make is in a retail customer's best interest.

The SEC and FINRA each have issued online guidance to assist broker-dealers in implementing their Reg BI compliance obligations. The regulators appear to be working together to avoid duplication and achieve consistency in guidance.

Guidance From the SEC

The SEC staff, for example, issued "Frequently Asked Questions on Form CRS" clarifying that each broker-dealer and investment adviser is to prepare only one relationship summary of "all of the principal relationships and services it offers" to retail investors no matter how many different services are offered to retail investors. The SEC staff FAQ on Form CRS also clarify relationship summary delivery scenarios. Another resource available on the SEC's website is a publication titled "A Small Entity Compliance Guide" that addresses Reg BI obligations, concepts, and terms of art.

Subsequently, the SEC staff has issued "Frequently Asked Questions on Regulation Best Interest." This document is divided into four sections, each of which provides additional guidance on an important aspect of the regulation:

- The concept of a "recommendation"
- The disclosure obligation
- The care obligation that is part of the standard of conduct
- The conflict of interest obligation

In order to assist firms with planning for compliance with the new rules, the SEC also has established an inter-Divisional Standards of Conduct Implementation Committee, and the SEC encourages firms to actively engage with this committee as questions arise in planning for implementation. Firms can send their questions by email to IABDQuestions@sec.gov.

In addition, the SEC staff has announced that, prior to the June 30 compliance date, it will engage with broker-dealers during examinations on their progress in implementing the new rules and questions they may have regarding the new rules. Again, however, the staff has characterized this pre-June 30 engagement with broker-dealers as being to "further assist" firms, rather than to find fault with them.

Guidance From FINRA

For its part, FINRA published a "Reg BI and Form CRS Firm Checklist" that sets forth 20 multipart steps to achieve Reg BI compliance and eight multipart steps to achieve Form CRS compliance as prescribed in the SEC adopting releases. FINRA's checklist identifies key differences between current FINRA rules and SEC Reg BI and Form CRS. FINRA also has established a Reg BI webpage containing various compliance resources.

Finally, in its January 9 "Risk Monitoring and Examination Priorities Letter," FINRA noted that, in the first part of 2020, it will review firms' preparedness for Reg BI to understand implementation challenges. After the June 30 compliance date, FINRA intends to examine firms' compliance with Reg BI, Form CRS, and related SEC guidance. In this regard, FINRA announced in the 2020 priorities letter that it may take into consideration the

following factors when reviewing a firm for Reg BI compliance:

- Does a firm have procedures and training in place to assess recommendations using a best interest standard?
- Does a firm and its associated persons apply a best interest standard to recommendations of types of accounts?
- If a firm and its associated persons agree to provide account monitoring, do they apply the best interest standard to both explicit and implicit hold recommendations?
- Does a firm and its associated persons consider the express new elements of care, skill, and costs when making recommendations to retail customers?
- Does a firm and its associated persons consider reasonably available alternatives to the recommendation?
- Does a firm and its registered representatives guard against excessive trading, irrespective of whether the broker-dealer or associated person "controls" the account?
- Does a firm have policies and procedures to provide the disclosures required by Reg BI?
- Does a firm have policies and procedures to identify and address conflicts of interest?
- Does a firm have policies and procedures in place regarding the filing, updating, and delivery of Form CRS?

By attending as soon as possible to the numerous and complex preparations required for blastoff, broker-dealers can greatly reduce the possibility of fizzling out on the launch pad when the clock hits zero.

Clarity on Application of California Usury Law: Insurers Not Subject to Compound Interest Limitations

BY TODD FULLER AND STEPHANIE FICHERA

The California Supreme Court recently handed Northwestern Mutual Life Insurance Co. a decisive victory in a putative class action challenging the insurer's assessment of compound interest on policy loans, holding that insurers are not subject to the compound interest limitations of California's usury laws.

Answering a question from the Ninth Circuit Court of Appeals in *Wishnev v. Northwestern Mutual Life Insurance Co.*, the California Supreme Court unanimously ruled that insurers are exempt from a century-old voter initiative, which requires lenders to obtain borrowers' signed consent before compound interest can be charged on loans.

The 1918 voter initiative was designed to provide a uniform approach to the maximum allowable interest rate applicable to all loans and lenders. Among other things, the 1918 initiative provides that interest may not be compounded "unless an agreement to that effect is clearly expressed in writing and signed by the party to be charged therewith." In 1934, the voters amended the California Constitution to address interest rates and exempt certain lenders from these restrictions. As a result, specified lenders, including insurers licensed to do business in the state, were now exempt from the interest rate limitations. The 1934 amendment, however, made no mention of compounding interest. Thus, the question for the California Supreme Court was whether these exempt lenders remained subject to the 1918 initiative's compound interest restrictions.

The court noted that these laws were "far from a model of clarity," and the "interplay among these sources continues to generate confusion." However, after a lengthy discussion of the history of the 1918 initiative, voter-approved constitutional amendments, and various "statutes scattered throughout various codes regulating lenders considered exempt," the court concluded that "the 1934 amendment impliedly repealed the compound interest limitation as to exempt lenders," like Northwestern Mutual. The court cautioned that "[t]his conclusion does not mean exempt lenders may charge compound interest without a contractual or legal basis to do so," but "simply means they are not subject to statutory liability and penalties otherwise imposed by the 1918 initiative on nonexempt lenders."

Second Circuit Opens Door to Lawsuits Based on Contract Violating 1940 Act

BY GARY COHEN

The Second Circuit has decided that Section 47(b) of the Investment Company Act of 1940 provides a private right of action for rescission of a contract that violates any provision of the 1940 Act or any rule or order thereunder. The decision was handed down in *Oxford University Bank v. Lansuppe Feeder LLC* last August.

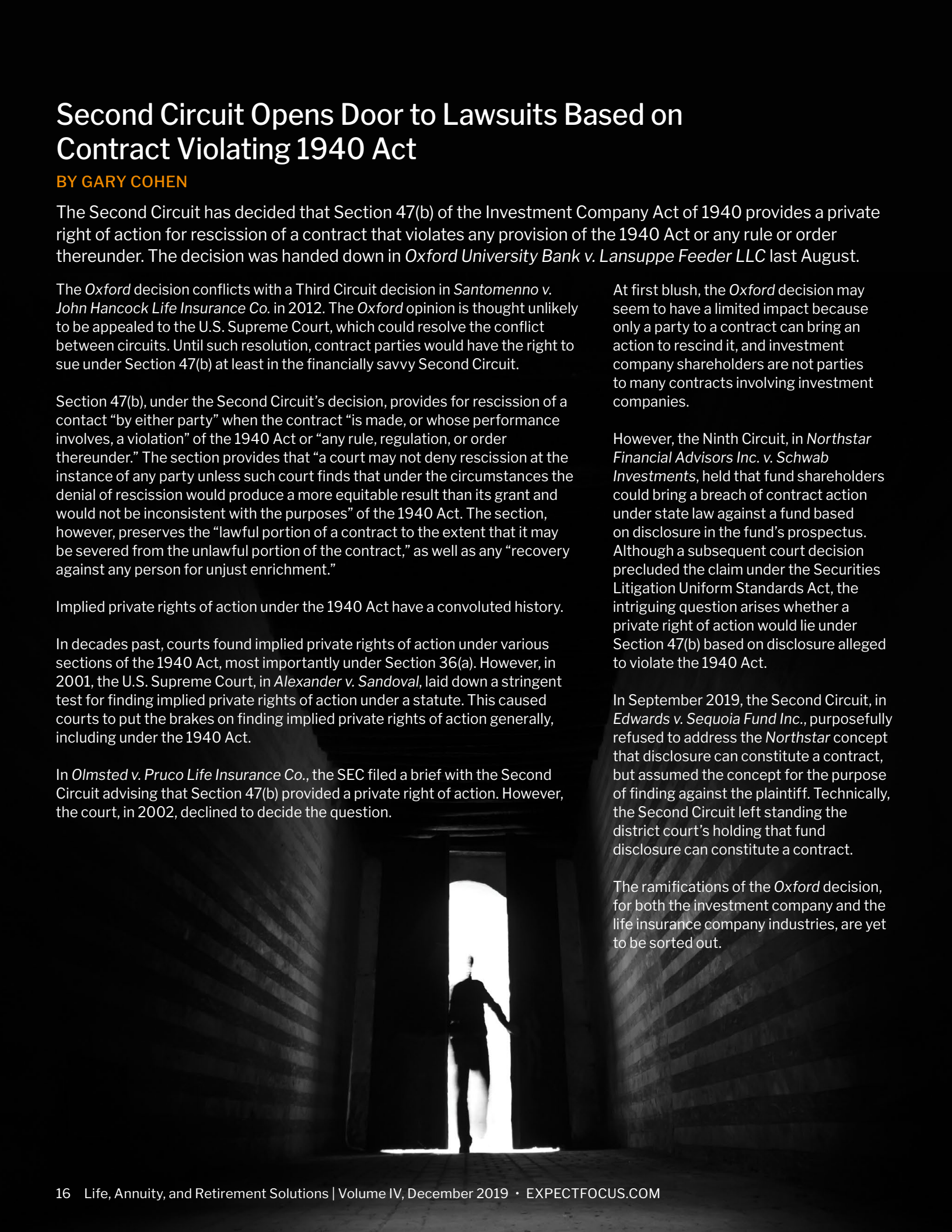
The *Oxford* decision conflicts with a Third Circuit decision in *Santomenno v. John Hancock Life Insurance Co.* in 2012. The *Oxford* opinion is thought unlikely to be appealed to the U.S. Supreme Court, which could resolve the conflict between circuits. Until such resolution, contract parties would have the right to sue under Section 47(b) at least in the financially savvy Second Circuit.

Section 47(b), under the Second Circuit's decision, provides for rescission of a contact "by either party" when the contract "is made, or whose performance involves, a violation" of the 1940 Act or "any rule, regulation, or order thereunder." The section provides that "a court may not deny rescission at the instance of any party unless such court finds that under the circumstances the denial of rescission would produce a more equitable result than its grant and would not be inconsistent with the purposes" of the 1940 Act. The section, however, preserves the "lawful portion of a contract to the extent that it may be severed from the unlawful portion of the contract," as well as any "recovery against any person for unjust enrichment."

Implied private rights of action under the 1940 Act have a convoluted history.

In decades past, courts found implied private rights of action under various sections of the 1940 Act, most importantly under Section 36(a). However, in 2001, the U.S. Supreme Court, in *Alexander v. Sandoval*, laid down a stringent test for finding implied private rights of action under a statute. This caused courts to put the brakes on finding implied private rights of action generally, including under the 1940 Act.

In *Olmsted v. Pruco Life Insurance Co.*, the SEC filed a brief with the Second Circuit advising that Section 47(b) provided a private right of action. However, the court, in 2002, declined to decide the question.



At first blush, the *Oxford* decision may seem to have a limited impact because only a party to a contract can bring an action to rescind it, and investment company shareholders are not parties to many contracts involving investment companies.

However, the Ninth Circuit, in *Northstar Financial Advisors Inc. v. Schwab Investments*, held that fund shareholders could bring a breach of contract action under state law against a fund based on disclosure in the fund's prospectus. Although a subsequent court decision precluded the claim under the Securities Litigation Uniform Standards Act, the intriguing question arises whether a private right of action would lie under Section 47(b) based on disclosure alleged to violate the 1940 Act.

In September 2019, the Second Circuit, in *Edwards v. Sequoia Fund Inc.*, purposefully refused to address the *Northstar* concept that disclosure can constitute a contract, but assumed the concept for the purpose of finding against the plaintiff. Technically, the Second Circuit left standing the district court's holding that fund disclosure can constitute a contract.

The ramifications of the *Oxford* decision, for both the investment company and the life insurance company industries, are yet to be sorted out.

2019 Year-End Class Action Roundup

BY IRMA SOLARES

Life insurers bid farewell to a fairly moderate year of class action litigation. Although several class actions were filed against life insurers in the last quarter of 2019, the filings were reflective of the litigation trends within the past few years, including challenges to interest crediting under fixed indexed deferred annuities and cost of insurance expenses.

Fixed Indexed Deferred Annuities

On opposite sides of the country, two class action suits were filed within weeks of each other challenging fixed indexed deferred annuities. In the U.S. District Court for the **Central District of California**, the plaintiff challenged an alleged "fraudulent scheme" that consisted of the development and marketing of fixed indexed annuities that would provide above-market returns through uncapped participation in gains within certain proprietary indexes. The action sought certification of California and Illinois classes, and the complaint asserted violations of the California Unfair Competition Law and the Illinois Consumer Fraud and Deceptive Business Practices Act, and sought rescission and restitution for common law fraud. The action was short-lived as the plaintiffs filed a notice of voluntary dismissal just six weeks after filing the complaint.

In the second suit, filed in the **Southern District of Florida**, the plaintiff is seeking certification of a nationwide RICO class action and a Florida unjust enrichment subclass stemming from purported misrepresentations concerning the fixed indexed annuities' participation in certain proprietary indexes.

Cost of Insurance

Plaintiffs also continue to file cases challenging the amounts charged for cost of insurance (COI). New class actions were filed in the **Middle District of Florida**, the **Western District of Missouri**, and the **Western District of Washington**. The Florida action asks the court to certify a class of Florida and Texas consumers who had monthly COI charges deducted from their policies allegedly in excess of amounts specifically permitted by the terms of the policies because the insurer failed to reduce the COI rates to reflect the defendant's improving expectations as to future mortality experience. The action alleges common law claims for breach of contract, breach of the covenant of good faith and fair dealing, conversion, and declaratory relief.

Similarly, in Missouri, the plaintiff filed suit in state court to carve out a Missouri class from a pending nationwide (49-state) putative class action. The defendant insurer removed the action to the Western District of Missouri. Like the related action already pending in federal court, the new suit alleges that the defendant breached its duty to the plaintiff by failing to reduce COI rates to reflect the defendant's improving expectations as to future mortality experience.

In the Western District of Washington, the plaintiff seeks certification of a nationwide class (excepting policies issued in California and Missouri) and a Washington subclass in an action claiming that the defendant uses factors not authorized by the policies when determining the COI, which results in a higher COI. The plaintiff claims that this practice constitutes breach of contract, conversion, and violation of the Washington Consumer Protection Act, and seeks declaratory and injunctive relief.

Much of this type of class action litigation, particularly actions challenging index interest crediting under fixed indexed annuities and indexed universal life insurance policies, is certain to continue in 2020.

Third Circuit Application of Certified Questions Confirms STOLI Policies Void in New Jersey

BY BROOKE PATTERSON

We previously reported on the New Jersey Supreme Court's ruling on the validity of stranger-originated life insurance (STOLI) policies in the June 2019 issue of *Expect Focus — Life, Annuity, and Retirement Solutions*. In *Sun Life Assurance Company of Canada v. Wells Fargo Bank, N.A.*, a federal trial court originally concluded that a $5 million policy taken out on the life of Nancy Bergman, which had a trust as owner and beneficiary and which was eventually sold by investors to Wells Fargo, violated New Jersey's statutory requirement that the policyholder have an insurable interest in the life of the insured. The Third Circuit Court of Appeals ultimately certified two questions to the New Jersey Supreme Court:

1. Whether STOLI policies violate the public policy of New Jersey and are thereby void ab initio; and
2. If the policy is void, is a later purchaser, who was not initially involved, entitled to a refund of premium payments?

The New Jersey Supreme Court answered the first question in the affirmative, finding that policies procured with the intent to benefit persons without an insurable interest in the life of the insured violate public policy and are void ab initio. In response to the second question, the court held that, depending on the circumstances, a party may be entitled to a refund of premiums paid on a void STOLI policy, particularly in the case of a later innocent purchaser of the policy.

Based on the New Jersey Supreme Court's answers to its certified questions, the Third Circuit recently affirmed the district court's finding that the Bergman policy violated New Jersey public policy. The Third Circuit held that the policy was procured with the intent of benefiting the investors in the policy rather than anyone with an insurable interest in Bergman's life. The Third Circuit also agreed that allowing Sun Life to keep Wells Fargo's premium payments would be a windfall, as Wells Fargo was a later innocent purchaser of the policy and had no knowledge of the STOLI arrangement.

No Saving Grace for Policyholders

BY ELISE HAVERMAN

In *McHugh v. Protective Life Insurance*, the California Court of Appeal held that a statute requiring 60-day grace periods for term life insurance policies did not apply retroactively.

The beneficiaries of a term life insurance policy issued in 2005 challenged Protective Life's termination of the insured's policy. The policy was terminated following expiration of the policy's 31-day grace period for nonpayment of premium. The insured died four months later. The beneficiaries filed suit asserting claims for breach of contract and breach of the implied covenant of good faith and fair dealing, arguing that the insurer failed to comply with a newly enacted statute requiring a 60-day grace period.

The California statute requires that "all life insurance policies issued or delivered in California on or after [January 1, 2013] ... contain a grace period of at least 60 days" before the policy can be terminated for nonpayment of premium. Affirming the trial court's judgment, the appellate court concluded that the statute applies prospectively only to term life policies issued after January 1, 2013.

A statute applies retroactively if (1) it contains express language of retroactivity; or (2) other sources provide a clear and unavoidable implication that the legislature intended the statute to be retroactive. The *McHugh* court found no express language of retroactivity in the statute and concluded that the legislative history reflected that the legislature's intent was that the new law would apply only to those policies "issued or delivered" after January 1, 2013.

Because the term life insurance policy at issue in *McHugh* was issued and delivered to the insured in 2005 — eight years before the statute now in effect — the insured was not entitled to the extended, 60-day grace period.

The Risk and Reward of Life Insurance

No Recovery for Paying Premiums in Excess of Policy Face Amount

BY DIMITRIJE CANIC

Since we last reported on *Goostree v. Liberty National Life Insurance Co.* in the October 2019 issue of *Expect Focus — Life, Annuity, and Retirement Solutions*, the court granted the defendant's motion to dismiss all counts of the plaintiffs' complaint.

The plaintiffs alleged that the insurer targeted undereducated and unsophisticated consumers to induce them to buy insurance policies it knew required premiums that would exceed the face amount of the policies. The plaintiffs asserted various individual and class action claims for, *inter alia*, breach of contract; breach of the implied covenant of good faith and fair dealing; conversion; unjust enrichment; and negligence.

The court concluded that each of the plaintiffs' claims was deficient. Rather than pleading any cognizable claims, each count merely highlighted the nature of life insurance, which the court described as "a gamble" for both parties. The insurance company gambles that the insured will live long enough so that the company can collect premiums sufficient to cover the amount of the policy and potentially more. The insured gambles that he or she will not outlive the "break-even point" for the insurance companies.

Here, the court concluded that the plaintiffs gambled and lost, holding that the plaintiffs could not allege wrongdoing simply because they paid more premiums than the face amount of their policies. As the court explained, the insurance company assumes an increased risk in the early years of a life insurance policy so that, as an insured ages past the break-even point, the insured subsidizes the increased risk that comes from the insurance company's younger clients, who may die before they pay sufficient premiums to cover the face amount. "For both parties, life insurance is a gamble," the court noted. The court concluded that the plaintiffs could not now allege a cause of action merely because they lost their "bet" and lived well into their 80s, still paying premiums on their policies. The court, accordingly, dismissed the case in its entirety with prejudice.

Not So Fast: Court Upholds Denial of Request for Accelerated Life Insurance Payment

BY BROOKE PATTERSON

The Ninth Circuit recently affirmed a summary judgment ruling in favor of Minnesota Life Insurance Co. on all claims stemming from its denial of an accelerated life insurance payment.

In *Bancroft v. Minnesota Life Insurance Co.*, Minnesota Life issued a group term life insurance policy to Bancroft's employer. The policy contained an accelerated benefits policy rider, which provided for accelerated payment of the full death benefit if the insured had a terminal condition. The policy rider defined terminal condition as a condition that directly results in a life expectancy of 24 months or less. Additionally, the policy rider required that the insured provide evidence to show his or her life expectancy.

Bancroft was diagnosed with lymphoma and requested his accelerated benefit, providing a statement from his doctor that his life expectancy was 24 months. However, Bancroft's doctor relied on an outdated publication, and Minnesota Life's medical reviewer determined that Bancroft's life expectancy was 37 months. Because the medical reviewer was unable to determine that Bancroft's life expectancy was 24 months or less with 90% certainty, which was the company's standard, Minnesota Life denied Bancroft's request. The policy rider and denial letter gave Bancroft the right to request mediation or binding arbitration, which Bancroft disregarded, instead filing suit against Minnesota Life. The parties filed cross-motions for summary judgment on Bancroft's claims of breach of contract, bad faith, breach of Washington's Insurance Fair Conduct Act (IFCA), and breach of the Washington Consumer Protection Act (WCPA).

The trial court found that Minnesota Life did not breach the policy rider, as Bancroft did not provide sufficient evidence to support a 24-month life expectancy, and all the medical testimony in the case, including Bancroft's own doctor, agreed that the life expectancy exceeded 24 months. The trial court also found that even though Bancroft had the right to arbitration or mediation, he did not invoke that right. Further, the trial court granted summary judgment on the IFCA and WCPA claims as Minnesota Life's decision to deny the accelerated payment was not unreasonable given the evidence.

The Ninth Circuit affirmed the trial court's decision. Relying on the medical evidence and especially the testimony of Bancroft's own doctor, the Ninth Circuit held that it was reasonable for Minnesota Life to conclude that Bancroft's life expectancy exceeded 24 months and to deny the accelerated payment. The Ninth Circuit also emphasized that Washington law requires an insured to assert his or her right to mediation or arbitration before proceeding to litigation, which Bancroft failed to do.

Minnesota Life eventually paid the accelerated life insurance payment to Bancroft, who provided new information about his life expectancy through court filings, which met the requirement of terminal condition under the accelerated benefits policy rider.

NEWS & NOTES

Carlton Fields financial services regulatory attorneys participated in the 37th Annual Advanced ALI CLE Conference on Life Insurance Company Products, held on November 6–8 in Washington, D.C. Several attorneys spoke at the conference:

- **Ann Black** led a panel on key trends driving sales of fixed and fixed index annuities and life insurance products and related regulatory developments.
- **Richard Choi** co-chaired the two-day conference and co-led a pre-conference introductory workshop on the regulatory framework for life insurance company products and underlying investments.
- **Gary Cohen**, appearing at this conference for the 36th time, delivered a presentation on practical insights and key takeaways on important regulatory and litigation developments affecting insurance dedicated funds and advisers.
- **Chip Lunde** presented on a panel on new SEC Regulation Best Interest and related SEC matters.

Carlton Fields is a sponsor of the third annual American Bar Association Current Issues in FINRA Arbitration and Enforcement CLE program on February 22 in Fort Lauderdale, Florida. The three-panel program covers topics of interest to attorneys and regulatory professionals practicing before FINRA or otherwise working in the securities industry. Shareholder **Ann Furman** will moderate a panel on FINRA's examination findings and priorities for 2020.

Carlton Fields is hosting a California Consumer Protection Act (CCPA) Forum on March 3 in Los Angeles, California. The forum will help in-house counsel, chief privacy and information officers, and C-suite leaders understand the current landscape of the CCPA, including the status of the regulations, anticipated litigation and enforcement priorities, and potential changes to the law.

The firm is a sponsor of the Global Insurance Symposium, taking place April 21–23 in Des Moines, Iowa. The conference allows insurance and financial services executives to discover cutting-edge technologies impacting the industry, network with regulators and leaders in the field, and gain valuable knowledge.

The firm earned national first-tier rankings in the *2020 U.S. News and World Report and Best Lawyers®* Best Law Firms guide for several practices, including insurance law and securities/capital markets law. The firm also received high rankings for a multitude of its practices in several metropolitan areas.

Carlton Fields welcomes the following attorneys to the firm: Shareholders **Christina Gagnier** (cybersecurity and privacy, Los Angeles) and **Rae Vann** (labor and employment, Washington, D.C.); Of Counsel **Steven Anapoell** (business transactions, Los Angeles), **Simon Gaugush** (white collar crime and government investigations, Tampa), and **Richard Tschantz** (government law and consulting, Tampa); and Associates **Dimitrije Canic** (life, annuity, and retirement litigation, Miami), **Darnesha Carter** (business litigation, Tampa), **Chael Clark** (property and casualty insurance, New York), **James Czodli** (business litigation, Miami), **Brianna Donet** (business litigation, Miami), **Alexander Hegner** (real estate and commercial finance, Atlanta), **Scott Menger** (business litigation, Los Angeles), **Luigi Orengo** (creditors' rights and bankruptcy, Tampa), **Katelyn Sandoval** (securities and derivative litigation, New York), **Michael Shepherd** (business litigation, Miami) and **Michael Zilber** (business litigation, Miami).

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