LIFE, ANNUITY, AND RETIREMENT SOLUTIONS INDUSTRY

Volume II, June 2019

EXPECTFOCUS®

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EXPECTFOCUS®

LIFE, ANNUITY, AND RETIREMENT SOLUTIONS JUNE 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.

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Changes to the Index Product Illustration Requirements Are No Child's Play

BY ANN BLACK AND JAMIE BIGAYER

The NAIC's Annuity Disclosure Working Group and IUL Illustration Subgroup continue to chalk out changes to the Annuity Disclosure Model Regulation (Model) and Actuarial Guideline 49 (AG 49) to address index product innovation.

Annuity Disclosure Working Group

The Annuity Disclosure Working Group held class on May 13 and June 5 to discuss the March 7 draft revisions to the Annuity Disclosure Model Regulation, which proposes to modify the requirements applicable to illustrations of index accounts. During those calls, the Working Group discussed the requirements that:

- The index be in existence at least 20 years.

  Birny Birnbaum argued that an index must be around at least 20 years to be able to illustrate the 10-year low and high scenarios to show consumers how index volatility impacts the interest credited. He asserted that less than 20 years would not show meaningful differences in the low and high scenarios. He and several regulators were also concerned that composite indices could be "drawn up" to illustrate favorably by data mining recent historical experience. Regulators also believed that some seasoning of the index helps ensure that the index is not arbitrarily being put together.

- The index may only be comprised of other indices.

  Various commenters raised their hands pointing out that erasing the term "components" from the Model would exclude indices that are based on ETFs, futures contracts, and other financial instruments that are commonly used in indices. Regulators were hesitant to use components out of concern that things "may get out of hand" unless components are defined.

- The index algorithm or method be fixed.

  Hands were also raised to object to the language requiring that the index algorithm or method be fixed. Commenters noted that this requirement is too restrictive, and that there are market reasons for changes in the algorithm or method, including where the construction of the underlying index changed.

- The index algorithm or method be available for inspection by regulators and consumers.

  Commenters also questioned whether requiring the algorithm or method to be available for inspection by consumers would cause more consumers to be confused. All agreed that consumers need to understand how the index operates and how its value can change. The Working Group noted that the level specificity of what needs to be disclosed is not yet settled.

After the June 5 call, the issues remain unsettled. The Working Group will schedule one more class to continue the lesson.

IUL Illustration Subgroup

The IUL Illustration Subgroup held class on May 28 to discuss a menu of options for enhancing IUL illustrations, reflecting comments from all the papers submitted to the Subgroup. While the menu contained 23 different subjects, the meeting focused on the options that are considered "beyond disclosure," because they require changes to AG 49 and possibly beyond. During the discussion, Mr. Birnbaum asserted that a complete overhaul of the illustration requirements is needed, as he does not believe merely adding more charts or disclosures to AG 49 would be sufficient. The chair assigned homework and asked for comments on the following options:

- Clarify whether charges can impact assumed earned interest underlying the AG 49's 'disciplined current scale.'
- Limit the use of variable/index loans.
- Have consistent treatment of various IUL product types.
- Apply AG 49 constraints to cash value internal rate of return. ■

Unpacking the SEC's Regulation Best Interest Package

BY ANN BLACK, RICHARD CHOI, ANN FURMAN, TOM LAUERMAN AND CHIP LUNDE

On June 5, 2019, the SEC adopted a four-part regulatory package that includes: new Regulation Best Interest (Reg. BI), the related "Relationship Summary" disclosure form (Form CRS), and two interpretations of the Advisers Act, one on the standard of conduct applicable to investment advisers (IAs) (the IA Interpretation) and the other on the "solely incidental" prong of the broker-dealer (BD) exemption from IA registration. The SEC set June 30, 2020, as the compliance date for Reg. BI and Form CRS. The Advisers Act interpretations, while technically effective on the date of their publication in the Federal Register, purport to "reaffirm" existing interpretations of an IA's fiduciary duties. We address below some of the preliminary questions firms and their legal and compliance staffs may have as they try to unpack the SEC's regulatory package.

Q How does a BD's standard of conduct under Reg. BI differ from that of an IA?

A According to the SEC, a BD's standard of conduct obligations under Reg. BI are "more prescriptive" than an IA's fiduciary duty obligations, which are principles-based. Reg. BI generally requires a BD and its natural associated persons (Associated Persons) to act in their retail customers' best interest and not place their own interests ahead of their customers' interests when recommending securities transactions or investment strategies involving securities (Securities Recommendations). However, this general obligation can be satisfied only by satisfying Reg. BI's four prescriptive component obligations: the "Disclosure Obligation," the "Care Obligation," the "Conflict of Interest Obligation," and the "Compliance Obligation."

The IA Interpretation describes an IA's fiduciary duty as including both a "duty of care" and a "duty of loyalty," ***both*** of which it says are encompassed by the "overarching principle" to act in the "best interest" of a client. In other words, according to the SEC, in fulfilling its fiduciary duty to act in the best interest of a client, an IA must satisfy ***both*** a duty of care and a duty of loyalty. Although Reg. BI does not describe a BD's best interest standard of conduct to include an explicit duty of loyalty, it does impose obligations that are consistent with an IA's duty of loyalty, such as the following:

An IA	A BD
Must not subordinate its client's interests to its own, i.e., cannot place its interest ahead of a client's interest	Cannot place its own interest ahead of the customer's interest when making a Securities Recommendation
Must make full and fair disclosure, in writing, of all material facts relating to the advisory relationship and the capacity in which it is acting, including through the Relationship Summary and the IA's Form ADV brochure	Must, under the Disclosure Obligation, including through the Relationship Summary, disclose the capacity of the BD, material fees and costs that apply, types and scope of services to be provided, including any material limitations on Securities Recommendations
Must eliminate or make full and fair disclosure of all material conflicts of interest	Must eliminate or mitigate certain conflicts of interest and make full and fair disclosure of all material facts relating to conflicts of interest

Q What standard applies to a dually registered financial professional?

A The standard of conduct that applies is based on the nature of the relationship the financial professional will have with the retail investor. The capacity in which the financial professional is acting would be set forth in a Relationship Summary that is delivered to the investor. Reg. BI treats an account recommendation (e.g., advisory or brokerage account) as an investment strategy recommendation. Whether Reg. BI applies, however, would depend on the capacity in which the financial professional is acting. According to the SEC, Reg. BI would not apply, for example, to a dually registered financial professional of a dually registered IA/BD who acts in the capacity of an IA in recommending a fee-based account. In that case, the Advisers Act standard of conduct would apply according to the SEC. This type of line-drawing, however, may present potential difficulties for firms responsible for supervising the activities of their dually registered financial professionals.

Q For retail customer accounts in existence on or before June 30, 2020, when must firms provide the Relationship Summary?

A Firms must deliver their Relationship Summaries to all existing retail investors on an initial one-time basis within 30 days after the date when the firm is first required to file its Relationship Summary through Web CRD (for BDs) and IARD (for IAs).

Q Will BDs be able to satisfy the Disclosure Obligation by providing the Relationship Summary?

A Generally no. The SEC expects that in most instances, BDs will need to provide information beyond that contained in the Relationship Summary (including as reflected in the below Q&A's).

Q How can a BD make the various disclosures required by the Disclosure Obligation?

A The Disclosure Obligation requires full and fair disclosure of various matters to be in writing. That said, the SEC acknowledged the need for flexibility in various situations, such as oral updates to supplement written disclosures with information not reasonably known at the time the disclosures were provided, e.g., disclosures relating to conflicts of interest or the capacity in which a dual registrant is acting. Also, in the case of product-level fees, the SEC would permit "an initial standardized disclosure of product-level fees generally (e.g., reasonable dollar or percentage ranges), noting that further specifics for particular products appear in the product prospectus, which will be delivered after a transaction in accordance with the delivery method the retail customer has selected, such as by mail or electronically."

Q Must BDs disclose the basis for each Securities Recommendation?

A No. The SEC stated in the adopting release for Reg. BI that it did not require BDs to disclose to retail customers the basis for each Securities Recommendation.

CONTINUED

Q Can firms satisfy their disclosure obligations by merely stating that they "may have a conflict of interest"?

A Not if a conflict actually exists. In this regard, the IA Interpretation notes that:

> [D]isclosure that an adviser "may" have a particular conflict, without more, is not adequate when the conflict actually exists. ... On the other hand, the word "may" could be appropriately used to disclose to a client a potential conflict that does not currently exist but might reasonably present itself in the future.

Q Must a BD recommend the least costly or least remunerative security or investment strategy?

A No. According to the SEC, merely doing so would not satisfy the Care Obligation. A BD must also evaluate the facts and circumstances of the particular recommendation and the particular retail customer's investment profile. As an example of factors to consider, the SEC noted:

> [P]rior to recommending a variable annuity to a particular retail customer, broker-dealers should generally develop a reasonable basis to believe that the retail customer will benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit.

Q Must a BD conduct an evaluation of every possible investment alternative, either on the firm's platform or outside the firm, such as where the firm only offers proprietary products or a limited range of products?

A No. The SEC did not require a BD to recommend the "single 'best' of all possible alternatives that might exist, in part because many different options may in fact be in the retail customer's best interest." In addition, the SEC did not require an Associated Person of the broker-dealer "to be familiar with *every* product on a broker-dealer's platform." An Associated Person is required "to conduct a review of such reasonably available alternatives that is reasonable under the circumstances" and firms are required to have a reasonable process for establishing and understanding the scope of what reasonably available alternatives would be considered.

Q Must BDs mitigate or eliminate all "firm-level" financial incentives that could be considered to give rise to a conflict of interest?

A No. The SEC decided to allow most firm-level conflicts to be addressed through disclosure.

Q Must BDs eliminate all sales contests, sales quotas, etc.?

A No. The requirement to eliminate sales contests, sales quotas, bonuses, and noncash compensation applies to sales of specific securities or specific types of securities within a limited period, but not to compensation practices based on, for example, "total products sold or asset growth or accumulation, and customer satisfaction." In addition, Reg. BI would not necessarily prohibit BDs from:

- Providing incentives to Associated Persons who may focus their business on general categories of securities (such as variable annuities); or
- Offering proprietary products or a limited menu of products and incentivizing the sale of such products, provided the incentive is not based on the sale of specific securities or types of securities within a limited period of time.

Q May a BD or its Associated Person offer or recommend only proprietary products or limited product or investment strategy menus?

A Yes. However, the BD or Associated Person must disclose material limitations and any related conflicts of interest and must prevent such limitations and conflicts from causing the BD or Associated Person to make Securities Recommendations that place their interests ahead of their retail customers' interests.

Q Must BDs identify and mitigate certain Associated Person-level conflicts?

A Yes. The Conflict of Interest Obligation requires BDs to identify and mitigate conflicts of interest that create an incentive for an Associated Person to place his or her interests or the interests of the firm ahead of the interests of the retail customer. According to the SEC, examples of incentives that need to be addressed include an Associated Person's (i) compensation for services provided and products sold; (ii) employee compensation or employment incentives; and (iii) commissions or other fees or financial incentives or differential or variable compensation. ▪

Proposed Revisions to ASOP 2 May Impact Your Product Pricing and Litigation Exposure

BY CLIFTON GRUHN AND STEVEN KASS

The Actuarial Standards Board (ASB) exposed wholesale changes to Actuarial Standard of Practice No. 2 - Nonguaranteed Charges or Benefits for Life Insurance Policies and Annuity Contracts (ASOP 2), which has not changed since 2004. ASOP 2 provides actuaries guidance for determining nonguaranteed elements (NGEs) in individual and certain group life insurance and annuity products. NGE determinations, such as cost of insurance (COI) rate increases, have spawned widespread class action litigation, state investigative and enforcement actions, and, most recently, new NGE-related state regulations (e.g., N.Y. Regulation 210).

Although ASOP 2 applies only to actuaries, insurers should be alert to its indirect impact on their NGE processes and pricing. The exposed changes mandate expanded and more prescriptive technical requirements for actuaries' NGE determinations, provide specific guidance concerning opinions and disclosures, and require a broader array of disclosures in actuarial reports. Some of the most significant proposed changes and potential implications include:

- Important definitional changes. For example, the respective lists of "examples" in the definitions of "Anticipated Experience Factor" and "Guaranteed Policy Factor" have been modified.
- The new definition, "NGE Framework" imposes enhanced duties on actuaries when considering each of the Framework elements and their interplay, including understanding a comprehensive list of methodologies and models used by the insurer.
- New, detailed requirements apply when actuaries are advising an insurer on: (i) developing or modifying its determination policy; (ii) applying the determination policy; (iii) establishing or changing policy classes, including separate, differing requirements in the context of new products, future sales of existing products, and in-force products; and (iv) the determination process of NGE scales, again with separate, context-based prescriptive requirements, including those for reviewing or reconstructing prior determinations, analyzing experience, considering whether to recommend revisions to NGE scales, and determining revised NGE scales.
- Requiring actuarial advice on in-force products to be consistent with two overriding principles — NGEs are revised only if anticipated experience factors have changed, and NGEs are not revised with the objective of recouping past losses or distributing past gains.
- Actuarial reports must include disclosures relating to, among other things, results and observations from any profitability or sensitivity analyses, use of prior analyses and any reconstructed determinations or reasonable approaches used when prior determinations were not available or could not be reconstructed, and results from tests performed to ascertain whether illustrated NGE scales are supportable when using anticipated experience factors that are not more favorable than actual recent historical experience.

Comments on the current exposure draft are due by July 15, 2019. After the comment period closes, it is expected that the ASB will take about six months to determine whether to adopt ASOP 2 as exposed (or with changes not requiring further exposure) or to reexpose an updated version for comment. Assuming no reexposure or modification of the effective date provision, new ASOP 2 would apply to all actuarial services performed four months after adoption, most likely during the second quarter of 2020. Nonetheless, it behooves actuaries and insurers to take immediate note of how the proposed changes may impact new products under development and prospective repricing of existing products, including considerations relating to contract language, the insurer's determination policy, state filing and approval timelines, and the management of ongoing and potential future litigation. ■

SEC Adds to Guidance on Digital Assets

BY EDMUND ZAHAREWICZ

In April, the staff of the Securities and Exchange Commission provided two pieces of guidance concerning the application of the federal securities laws to digital assets. In particular, the SEC's Strategic Hub for Innovation and Financial Technology (FinHub) published a framework for analyzing whether a digital asset is a security, while the Division of Corporation Finance issued its first no-action letter to a market participant in connection with the proposed offer and sale of a digital asset.

The SEC's new FinHub, which launched last October, serves as a resource for public engagement on the SEC's FinTech-related issues and initiatives, such as distributed ledger technology (including digital assets), automated investment advice, digital marketplace financing, and artificial intelligence/machine learning. It also replaces and builds on the work of several internal working groups at the SEC that have focused on similar issues.

The FinHub framework discusses numerous types of facts and circumstances that one should consider under the U.S. Supreme Court's so-called *Howey* "investment contract" test when analyzing whether the federal securities laws apply to the offer, sale, or resale of a particular digital asset. While generally helpful, the framework is unlikely to bring certainty to many situations because it provides little guidance on the key subject of the relative weights that should be ascribed to the various factors under different factual scenarios.

The Division's no-action letter gave assurance for a proposed offer and sale, without registration under the Securities Act or the Securities Exchange Act, of blockchain-enabled digital tokens to facilitate the use of prepaid air charter services. As is typical of such letters, the letter does not explain the staff's rationale for granting no-action relief, but merely recites a number of the incoming representations that the staff found particularly noteworthy in reaching that position. Like the FinHub framework, therefore, the letter is of limited help in analyzing the status of digital assets when the facts differ significantly from those addressed in the letter.

Indeed, in a recent speech, SEC Commissioner Hester Peirce questioned the utility of the staff's guidance and expressed concern that its opaqueness might even encourage wary companies to forgo certain opportunities or to pursue them in more crypto-friendly jurisdictions. ■

DC Circuit: Willful Means Intentional Under the Advisers Act

Negligent Conduct Cannot Be Willful Conduct

BY ANN FURMAN

In *Robare Group v. SEC*, the court clarified the meaning of "willfully" under Section 207 of the Investment Advisers Act of 1940. A willful omission requires that a person "subjectively intended to omit material information."

So, when the SEC alleges inadequate financial disclosure — for example, Form ADV disclosure that does not address receipt of "revenue sharing" payments (e.g., shareholder servicing fees paid when clients invest in certain eligible funds on an online platform) or the potential conflict of interest to clients created by those payments — an investment adviser cannot be held liable for willful violations of the Advisers Act if the adviser's conduct was merely negligent.

Importantly, however, not all of the Advisers Act's anti-fraud provisions are predicated on "willful" misconduct. Thus, courts have held that a violation of Section 206(1) requires proof of scienter (i.e., an intent to deceive, manipulate, or defraud) and a violation of Section 206(2) requires proof only of simple negligence. But, prior to *Robare*, the courts had not addressed the meaning of "willfully" in Section 207, which makes it unlawful for any person to willfully make any untrue statement of material fact, or omit to state any material fact, in Form ADV or reports filed with the SEC.

Robare is important for several reasons. In addition to clarifying that negligent conduct (failure to exercise reasonable care under all circumstances) is not sufficient to establish a willful violation under Section 207, the court:

- reinforced the importance of disclosure (in Form ADV) of "revenue sharing" arrangements;
- emphasized the importance of full and fair disclosure of potential conflicts of interest created by "revenue sharing" arrangements; and
- confirmed that the "everyone else does it this way" defense is not sufficient to overcome a negligence allegation. Rather, the fact that an adviser's disclosure is consistent with industry practice does not mean that the adviser acted reasonably.

It also is possible that *Robare*'s interpretation of "willful" will be followed by other circuits or where that term appears in federal securities law provisions other than Section 207 of the Advisers Act. This could greatly amplify the decision's relevance for advisers and their counsel in defending against allegations of willful misconduct. ■

New Chair on the Block Discusses Reconstructing the Suitability Model

BY ANN BLACK AND JAMIE BIGAYER

Ohio Department of Insurance Director Jillian Froment, the new chair of the Annuity Suitability Working Group (Working Group), invited regulators and interested parties to build the required standard of care foundation for the Suitability in Annuity Transactions Model Regulation (Suitability Model) at a June 20 in-person meeting. During the meeting, Chair Froment used the Iowa Insurance Division's May 30 proposed draft revisions to the Suitability Model as the building blocks for the discussion. Chair Froment sought to reach consensus on the four obligation pillars of Iowa's Best Interest proposal — care, disclosure, conflict of interest, and documentation — as well as other structural pieces of Iowa's draft. While all agreed on the four pillars and reached consensus on many of the other pieces, the Working Group agreed that it needed to go back to the drawing board on several of the structural components.

Best Interest

As Chair Froment reviewed Iowa draft's requirement to act in the best interest of the consumer, New York's Deputy Commissioner James Regalbuto asserted that using language "without placing the producer's interest ahead of the consumer's interest" does not constitute best interest as "only the interest of the consumer" should be considered. Others thought this would be unattainable by producers. Deputy Commissioner Regalbuto posited that the Working Group could go forward with the standard as written, as long as "best interest" was not used. Commissioner Doug Ommen urged that "best interest" should be used in light of the SEC's Regulation Best Interest and the current marketplace.

Care Obligation

Commissioner Ommen explained that Iowa's draft reconstructed the suitability obligation into an elevated "professional standard" under which producers are required to know the products they recommend and know their customers. Iowa's draft includes specific processes to take place and requires the exercising of professional judgment in making a recommendation to consumers. By avoiding the SEC's facts and circumstances approach, Iowa's draft seeks to clarify the expectations on insurers and producers. Several questions remained on the actual configuration, including:

- Whether the producer should act with prudence?
- How will it be determined if the producer acted reasonably?
- How will it be determined if the annuity was appropriate for the consumer — "best suited" or "addresses the consumer's insurance needs and financial benefit"?

Disclosure Obligation

The regulators noted that Iowa's draft includes disclosure on:

- The producer and the producer-client relationship.
- The product being recommended.
- The basis of the recommendation and any conflicts of interest that exist in connection with the recommendation. Chair Froment posited that the disclosure obligation is intended to ensure that the consumer has the information needed to act on a recommendation. The Working Group discussed whether certain disclosures should be made "up front," similar to the SEC's Relationship Summary, and whether other disclosures should be made at the time of the recommendation or thereafter.

Conflict of Interest Obligation

The Working Group agreed that transaction-based compensation involves inherent conflicts of interest, but care should be taken not to eliminate this type of compensation. Commissioner Ommen explained that Iowa's draft requires conflicts of interest to be avoided or managed, primarily through disclosures. Many asserted that the proposed required disclosure is too detailed. Chair Froment also pointed out that a subsequent call would be needed on what is a conflict of interest and what is required if there is a conflict of interest.

Documentation Obligation

The documentation obligation would support that a producer acted in the best interest of each consumer and would be done contemporaneously or shortly following the transaction. Regulators considered the need for improved documentation of the recommendation discussions to facilitate reviews of consumer complaints, regulatory inquiries, and enforcement actions.

Supervision

The Working Group's discussions focused on whether the supervision requirement should require elimination of sales contests and should prevent producers from purposely limiting the products they make available.

* * * *

While Chair Froment was the new kid on the block, she fostered constructive discussions on the proposed Suitability Model, building consensus on numerous points and deferring the more difficult conversations for later building sessions. Chair Froment expects to hold three calls prior to the 2019 NAIC Summer Meeting. ■

Has OMB Reined in the SEC?

BY TOM LAUERMAN

An April 11, 2019, Office of Management and Budget Memorandum seeks to bring certain guidance issued by federal agencies, including the SEC, under more effective scrutiny. By its terms, the Memorandum applies to agency rules, as well as "agency statement[s] of general … applicability and future effect designed to implement, interpret, or prescribe law or policy."

The Memorandum states that such agency guidance "should" be submitted in advance to OMB, so that OMB's Office of Information and Regulatory Affairs can properly classify regulatory actions for purposes of the Congressional Review Act.

Memorandum's Impact on SEC Rulemaking

In theory, the Memorandum could result in increased OMB and congressional scrutiny — possibly leading to delay or overturning — of future SEC rules.

It is not clear, however, that the Memorandum is legally binding on the SEC, particularly in view of the SEC's status as an independent regulatory agency, as well as the Memorandum's use of the word "should," rather than "must" or "shall." In any event, the SEC, when adopting rules, already follows procedures that are generally consistent with those prescribed in the Memorandum.

Accordingly, the Memorandum probably will not saddle SEC rules with significant new burdens or obstacles. For example, although some observers speculated that the Memorandum might delay the SEC's recent releases governing standards of care for broker-dealers and investment advisers, this does not seem to have happened.

Impact on Guidance Provided by the SEC Staff

Commentators also have suggested that the Memorandum might impact some types of "no action," interpretive or other guidance that is provided by the SEC staff, rather than by formal action of the SEC's commissioners. In this regard, SEC Commissioner Hester Peirce has recently expressed concern that various types of nonpublic guidance provided by the SEC staff may become, in effect, an undesirable body of "secret law."

On the other hand, unlike SEC rules, staff guidance — whether public or nonpublic — is not legally binding on registrants. SEC Chairman Jay Clayton has recently emphasized that point (*see* "Use of Non-Binding SEC Staff Guidance Called Into Question," *Expect Focus – Life Insurance*, Vol. IV (Dec. 2018)), notwithstanding that informal guidance sometimes may have much the same importance to registrants as a formal rule. The Memorandum, therefore, seems even less likely to corral future SEC staff guidance than to rein in future SEC rules. ▪

SEC Staff Asks for Time

Feels Pressure From Automatic Filing Effectiveness

BY STEPHEN CHOI

On April 2, 2019, the SEC's Division of Investment Management published an "Accounting and Disclosure Information" statement calling for cooperation from registrants filing post-effective amendments under Rule 485(a).

Insurance companies filing amendments to registration statements for their variable product registration statements, as well as mutual funds, frequently rely on Rule 485(a). Under the rule, post-effective amendments filed by registrants automatically become effective in as little as 60 days without any staff action. In the statement, the Division raised the concern that the time until automatic effectiveness may be insufficient for the Division staff to review and address all issues in a filing.

To alleviate this problem, the statement:

- "urges" registrants filing under Rule 485(a) to contact the staff regarding any issues that may raise material questions of first impression before they file; and

- "requests" registrants either to respond to any staff comments on Rule 485(a) filings at least five days before the filings become effective automatically or to delay effectiveness until all such comments have been resolved.

However, as SEC officials, including Chairman Jay Clayton, have recently emphasized, a staff statement of this type is not legally binding. *See* "Has OMB Reined in the SEC" on page 12. Thus, the Division's statement merely "urges" and "requests" registrants to cooperate and does not discuss what the consequences, if any, might be for disregarding the staff's preferences as set out in the statement.

There are many reasons why, in a given case, registrants may wish to disregard those staff preferences. Accordingly, registrants will need to carefully weigh such considerations in light of each amendment's particular facts and circumstances. ■

Regulatory Response to Insurance Innovation

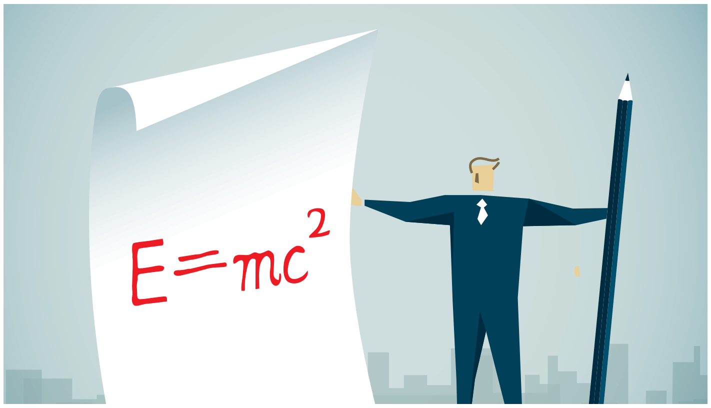
BY ANN BLACK AND JAMIE BIGAYER

As the insurance industry seeks to implement new technology, several NAIC groups and states are addressing the regulatory landscape to evolve with the changes.

Sandboxes

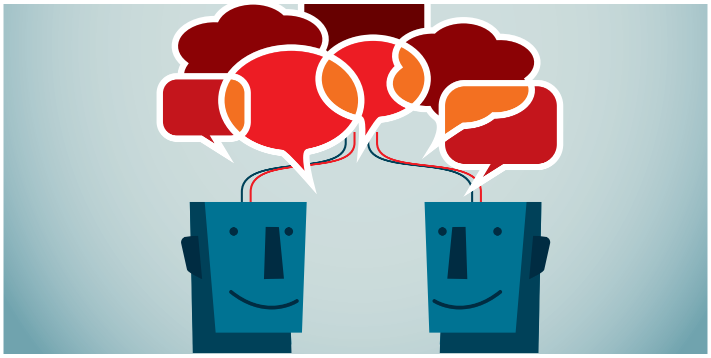
The Innovation and Technology Task Force (IT Task Force) heard presentations on the United Kingdom Financial Conduct Authority's sandbox and proposals for the creation of regulatory sandboxes. States have taken differing approaches. Some believe sandboxes are not necessary, or their legislature would not allow for sandboxes. Others, including Connecticut, Illinois, and Wisconsin, believe their current regulatory environment allows them to provide guidance to innovators without the need for a sandbox. States that have enacted legislation or regulations to establish sandboxes include:

- Arizona enacted a Regulatory Sandbox "to enable a person to obtain limited access to the market in [Arizona] to test innovative financial products or services without obtaining a license or other authorization that otherwise might be required."
- Utah enacted a Regulatory Sandbox Program, "which allows a participant to temporarily test innovative financial products or services on a limited basis without otherwise being licensed or authorized to act under the laws of [Utah]."
- Vermont enacted an Insurance Regulatory Sandbox, which allows the commissioner to grant a variance or waiver "with respect to the specific requirements of any insurance law, regulation, or bulletin," if certain conditions are met.
- Wyoming enacted a Financial Technology Sandbox "for the testing of financial products and services in Wyoming."



Review of Big Data and Algorithms

The NAIC's review of the life insurers and property and casualty insurers' use of algorithms continues. The Casualty Actuarial and Statistical Task Force is developing a white paper addressing sources of data, company selection of data, predictive models, and final rate filings with the states. The Big Data WG asked the Life Insurance and Annuities Committee in collaboration with the Experience Reporting Subgroup to study the use of external data and data analytics in accelerated life underwriting, and draft and propose appropriate state guidance or best practices. The Big Data WG is also studying the use of big data in insurer claim practices such as claim valuation and anti-fraud efforts.Us

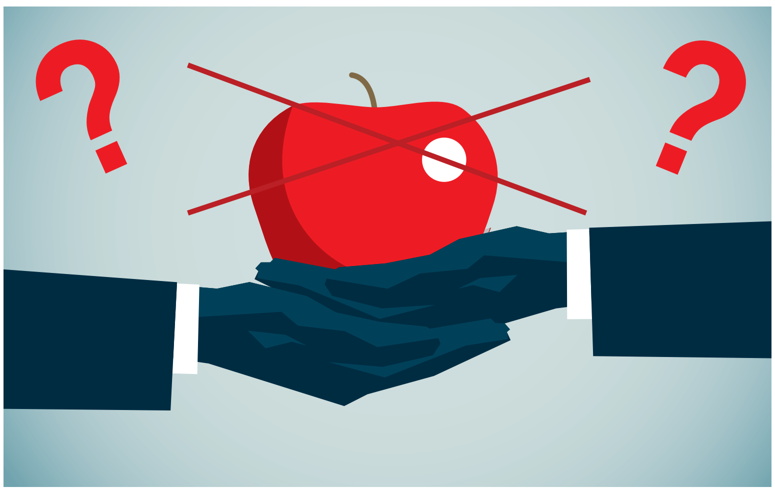


Chatbots

Following presentations the IT Task Force heard from innovators on the use of chatbots to provide information to consumers, the Producer Licensing Task Force was charged to "[d]raft a white paper on the role of chatbots and artificial intelligence in the distribution of insurance and the regulatory supervision of these technologies." The Producer Licensing Task Force is seeking comments before it begins creating an outline and initial draft. No deadline has been set for the receipt of comments.

Rebating

The IT Task Force identified anti-rebating laws as one of three perceived and real obstacles to innovation in insurance. It formed a small group to examine anti-rebating laws and discovered that while there was no consistency in state law, the Unfair Trade Practices Act (#880) generally restricts any rebate of premium, any special favors, or providing any valuable consideration not specified in the policy. The NAIC Legal Division found that state guidance focuses on limiting the promotional or advertising materials as well as limiting the types of "value-added services" that may be offered. The IT Task Force held a June 4 meeting to discuss the anti-rebating laws and what changes are needed to foster innovation. All agreed that the anti-rebating law was needed, but should be revised to incorporate flexibility. The IT Task Force is considering the following proposed three-part test:



- Does the value-added service or product harm an insurer's solvency?
- Does the value-added service or product directly relate to the insurance policy?
- Is the value-added service or product offered on a nondiscriminatory basis?

If all questions could be answered in the affirmative, there would be no rebate. In addition, it was suggested that the anti-rebating laws include an exception for services or products that "educate, assess, monitor, or control risk of loss."

Questions arose as to:

- Whether merely including policy language that allowed for value-added services or products, such as those for risk mitigation, would be a solution. Some commented that the lag time and no stated standard for policy approval are impediments. Also, this solution may not address situations in which the producer or broker provides the service or product.
- Whether anti-rebating laws should apply only to consumer, and not commercial, purchasers of insurance.

Regulation of Data Points

As states become aware that new data is being funneled for use in marketing, rating, underwriting, fraud, and claims handling by insurers, more states have enacted or introduced legislation or regulations limiting the use of specific data.

Examples include:

- New York banned motor vehicle insurers from discriminating based on education or occupation.
- Maryland introduced private passenger motor vehicle legislation prohibiting underwriting, canceling, refusing to renew, rating a risk, or increasing a renewal premium based, in whole or in part, on the occupation of, or on the education level attained by, the insured or applicant.
- Maryland also introduced homeowners insurance legislation prohibiting premium increases based solely on the insured's change in marital status due to a spouse's death.
- Florida introduced legislation prohibiting life insurers, long-term care insurers, and disability income insurers from using genetic information or genetic testing of applicants.

While many measures were not approved, their introduction reflects states' growing concerns as to the use of certain data. In addition, the Big Data WG passed a motion to request that the Life Insurance and Annuities Committee study the use of external data and data analytics in life underwriting, and draft and propose guidance and best practices for this use. ■

Supreme Court Casts a Wide Net with Rule 10b-5

BY MICHAEL YAEGER

The U.S. Supreme Court recently held that someone doesn't need to have "made" a false or misleading statement to have primary liability under the securities fraud rules.

Although the outer limits of that liability are not yet defined, this decision should cause persons with ancillary roles in securities transactions to be even more attentive to the accuracy of disclosures. Affected people could include:

- Broker-dealer firms whose representatives provide customers with disclosures about mutual funds and securities-based insurance products sold through the firm; and
- In some circumstances, legal, accounting, or business personnel who prepare, but do not have ultimate authority over, those disclosures.

Historically, most securities fraud actions have been brought under SEC Rule 10b-5(b), which governs those who "make" false or misleading statements. And the Supreme Court held in 2011 that one does not "make" a statement without ultimate authority over the contents of the statement and whether and how to issue it. But in its March 2019 opinion in *Lorenzo v. SEC*, the Supreme Court interpreted subsections (a) and (c) of the Rule (and the relevant statutory sections), and made clear that primary liability under those sections is not limited to persons with ultimate authority over statements.

Francis Lorenzo was an employee at an SEC-registered brokerage firm. He was helping to sell debentures in a company, and he sent emails to prospective investors that he knew contained materially false statements about the value of the company's assets. The content of the emails was written by Lorenzo's boss and Lorenzo sent them at his boss's direction, but the Supreme Court held that Lorenzo can be primarily liable under 10b-5(a) or (c).

As then-Judge Kavanaugh wrote in his dissent in the opinion below when he was on the D.C. Circuit, "the distinction between primary and secondary liability matters, particularly for private securities lawsuits." The Supreme Court has held that private litigants cannot bring 10b-5 claims against people who merely aid and abet primary actors. The majority opinion in *Lorenzo* therefore allows for more private lawsuits than would have been possible under the dissent's preferred holding.

Illinois Supreme Court Nails Down Status in Big Market: Indexed Annuities Are Not Securities

BY GARY COHEN

In *Van Dyke v. White*, the Illinois Supreme Court has held that fixed indexed annuities are not securities under Illinois law.

The decision is significant because it:

- reverses a decision of the Illinois securities department that indexed annuities were securities in an agent disciplinary proceeding; and
- establishes legal certainty on this point for sales in Illinois, which is said to be the third-largest state retirement market.

Illinois securities law defines "security" to include a "face amount certificate," and defines "face amount certificate" to include "any form of annuity contract (other than an annuity contract issued by a life insurance company authorized to transact business in this State)." The Illinois Securities Department agreed that the fixed indexed annuities in the case were not securities under this provision.

However, the Illinois Securities Department found the fixed indexed annuities to constitute "investment contracts" under the Illinois definition of "security." The department argued that the provision was "patterned after" the definition of "security" in the Securities Act of 1933 and, therefore, had to be construed along the lines of the U.S. Supreme Court decisions that found variable annuities to be investment contracts and a U.S. court of appeals decision that, in effect, found the SEC could reasonably determine fixed indexed annuities to be investment contracts.

In *Van Dyke*, the Illinois Supreme Court ruled against the Illinois Securities Department based, in short, on the ground that the specific definition of "face amount certificate" took precedence over the "general descriptive designation" of "investment contract."

Carlton Fields filed an amicus brief on behalf of the American Council of Life Insurers urging the *Van Dyke* court to hold that fixed indexed annuities were not securities under Illinois law. For additional information about the lower court rulings in this and a related case, see "Illinois Courts: Fixed Indexed Annuities Are Not Securities," *Expect Focus – Life Insurance*, Vol. III (Oct. 2016). ■

Life Insurer Defeats Bid to Apply Policy Lapse Statute Retroactively

BY MICHAEL WOLGIN

In *Smith v. Jackson National Life Insurance Co.*, a beneficiary of a life insurance policy that lapsed prior to the death of the insured sued Jackson National for failing to provide sufficient notice of termination and wrongfully denying the death benefit.

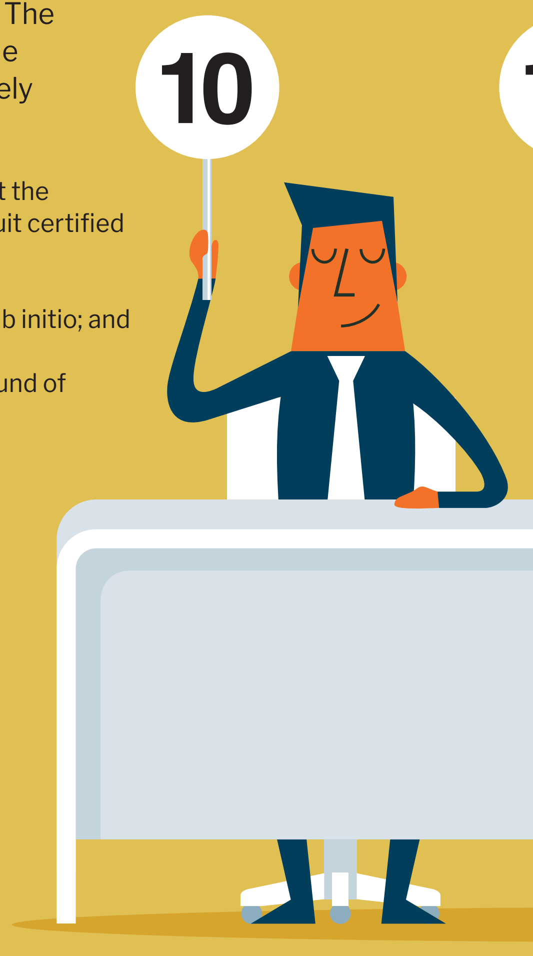
The policy was issued in 1997, and it was governed by Utah law. Five years after the policy issued, the Utah Legislature passed section 31A-22-402(5), providing, in pertinent part, that the "insurer shall send written notice of termination of coverage ... at least 30 days before the date that the coverage is terminated." The beneficiary claimed that Jackson National violated this law by sending written notice that immediate payment was due only 11 days prior to terminating the policy. The insured failed to make any payments, and died two days after the date of the lapse — on the very day that the final "Notice of Policy Lapse" was mailed by Jackson National. The beneficiary argued that, due to insufficient notice, the policy should not have been terminated and the death benefit should have been paid.

Jackson National moved for summary judgment, arguing that: (1) the statute did not retroactively apply; (2) Jackson National complied with the statute based on prior notices sent to the insured; and (3) the statute did not provide the plaintiff with a private right to sue. The court agreed with the first argument (rendering the other arguments moot), holding that the law in effect at the time the policy was issued "became a part of the parties' insurance contract" and that the statute did not apply retroactively because the Utah Legislature never declared that intent, and because the statute created substantive contractual rights rather than mere "practice and procedure." The court found that the plaintiff's claim failed as a matter of law, and entered judgment for Jackson National. ■

STOLI Policies Void in New Jersey

BY BROOKE PATTERSON

The New Jersey Supreme Court recently held stranger-originated life insurance (STOLI) policies void as against public policy. In *Sun Life Assurance Co. of Canada v. Wells Fargo Bank, N.A.*, a $5 million policy was taken out on the life of Nancy Bergman, with a trust as owner and beneficiary. The trust included investors who paid the policy's premiums. The investors became successor co-trustees, and authorized to sell the policy. The investors ultimately sold the policy, and, after a second sale, Wells Fargo acquired the policy.



The trial court concluded that the policy violated New Jersey's statutory requirement that the policyholder have an insurable interest in the life of the insured. On appeal, the Third Circuit certified two questions:

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

The court concluded that STOLI policies were against public policy and void from the beginning. However, the court recognized that circumstances existed where a life policy sold to an investor would be enforceable. A key factor in the unenforceability of the policy here was the swift transfer of control to investors who had no insurable interest. The court stated that an incontestability provision would not bar a challenge to STOLI policies, which were contrary to public policy. Finally, the court found that, depending on the circumstances, a party may be entitled to a refund of premium payments made on a void STOLI policy. The court noted that a refund may particularly be appropriate for an innocent later purchaser of a STOLI policy. ■

Class Certification Denied in Universal Life "Risk Rates" Litigation

BY STEPHANIE FICHERA

Individualized defenses and choice-of-law issues played a key role in preventing class certification in a recent challenge to a life insurer's discretion to adjust its "risk rates" on universal life (UL) insurance policies.

In *Taylor v. Midland National Life Insurance Co.*, the plaintiff challenged the insurer's calculation of a "monthly deduction" from the account value of its UL policies. The monthly deduction was the sum of an "expense charge" and a "risk charge." In calculating the "risk charge," the insurer applied a "risk rate"; increase of the risk rate would also increase the risk charge, which, in turn, would increase the monthly deduction. The UL policies provided that the "risk rate" was based on the "Attained Age, sex, and Premium Class of the Insured" and that "Risk Rates are declared by Us based on Our expectations of future mortality experience."

The plaintiff argued that the insurer breached its UL policies by including non-mortality factors — such as variations in funding patterns, surrender behavior, operating expenses, and investment returns — in its risk rate, and by not adjusting its risk rates downward as its mortality expectations allegedly improved.

In May, a federal district court in Iowa denied the plaintiff's motion for certification of a nationwide class, concluding that the plaintiff failed to satisfy the predominance requirement of Rule 23(b)(3).

Choice-of-Law Issues

After conducting a detailed choice-of-law analysis, the court determined that the laws of every state in which an insured was domiciled would apply to the class's claims. In particular, varying state laws regarding admission of extrinsic evidence made the case difficult to maintain as a nationwide class action. The UL policies at issue were sold through independent agents. The potential for a "parade" of testimony from agents regarding the parties' understanding of the policies' terms, their sales presentations, and their discussions of policy features created individual issues that predominated over common ones.

Statute of Limitations Defense

Moreover, it was undisputed that the insurer had stopped selling the UL policies at issue at least a decade before the action commenced and that former policy owners comprised the majority of the putative class. As such, the class had to overcome the insurer's statute of limitations defense. Although the court concluded that Iowa's statute of limitations applied uniformly to the class, the plaintiff's effort to avoid the defense by alleging equitable tolling created individualized issues that barred certification. The plaintiff argued that the putative class's claims should not be time-barred because the insurer concealed the factors it used to determine its risk rates from the class. But the record lacked any basis to conclude that the alleged fraudulent concealment could be shown by common proof; instead, the record suggested that agents may have given varying sales presentations and different explanations of how risk charges and risk rates were determined to class members, again creating individualized issues. ■

Considerations for Use of Arbitration Agreements to Curtail Class Claims

BY IRMA SOLARES

May 21, 2019, marks the one-year anniversary of the U.S. Supreme Court's decision in *Epic Systems Corp. v. Lewis*, which upheld the use of class action waivers in employee arbitration agreements.

In a 5-4 vote, the Supreme Court determined that the law is "clear" that class action waivers are enforceable under the Federal Arbitration Act (FAA) and that individual arbitration agreements do not conflict with the National Labor Relations Act's collective action guarantees. In upholding the "liberal federal policy favoring arbitration agreements," the Court held that Congress, through the FAA, has instructed federal courts to enforce arbitration agreements as written, and employers are free to compel employees, as a condition of employment, to require that arbitration proceed on an individual basis.

The decision was heralded as a much-needed reprieve for employers facing a mounting number of costly wage and hour and other collective employment practices litigation, so it is fitting to reflect on the decision's impact in the past year.

Epic's Impact During the Past Year

While it is too soon to determine *Epic*'s impact on the number of class and collective action filings since the decision, several courts of appeal have already weighed in on *Epic*:

First Circuit

Bekele v. Lyft, Inc. (in light of *Epic*, plaintiff unable to prevail on argument that agreement requiring individual arbitration violates the NLRA).

Fifth Circuit

In re JPMorgan Chase & Co. (reversing district court decision allowing class notice to be sent to putative class members who signed arbitration agreements with class waivers).

Sixth Circuit

Gaffers v. Kelly Servs., Inc. (holding that, like the NLRA, nothing in the Fair Labor Standards Act displaces the FAA or bars individual arbitration agreements); *McGrew v. VCG Holdings Corp.* (concluding that neither the NLRA nor the FLSA preclude individual arbitration agreements, and such agreements are enforceable against both employees and independent contractors).

Seventh Circuit

Herrington v. Waterstone Mortg. Corp. (reversing district court opinion that compelled arbitration but struck as unlawful the waiver clause forbidding class or collective arbitration, which resulted in a $10 million arbitration award against the employer).

Ninth Circuit

O'Connor v. Uber Tech. (reversing district court order denying Uber's motion to compel arbitration; *Miner v. Ecolab, Inc.* (vacating district court order denying employer's motion to compel arbitration and remanding for further proceedings).

Eleventh Circuit

Cowabunga, Inc. v. NLRB (reversing NLRB panel ruling holding that employer violated the NLRA by maintaining and enforcing employment agreements requiring that employment disputes be resolved through individualized arbitration); *Franks v. NLRB* (reversing NLRB ruling holding that arbitration agreements barring collective or class claims violated the NLRA).

What *Epic* Likely Will Not Cover

Arbitration agreements with class waivers do not (and cannot) prevent individuals from filing a charge with the U.S. Equal Employment Opportunity Commission (EEOC). The EEOC has the power to investigate workplace claims and to enforce workplace discrimination and harassment claims on behalf of one or more employees. And, as Justice Ginsburg noted in her dissent in *Epic*, she does not view the majority opinion "to place in jeopardy discrimination complaints asserting disparate-impact and pattern-or-practice claims that call for proof on a group-wide basis."

Challenges to Arbitrability: What Lies Ahead for Employers

1. ***Challenges to the enforceability of arbitration agreements under contract law analysis.*** Like all contracts, arbitration agreements must be supported by adequate consideration, meeting of the minds, mutuality of obligation, etc. In *Epic*, the Supreme Court made clear that arbitration agreements are still susceptible to defenses arising from the ***formation of the agreement***, for things such as fraud, unconscionability, duress, and illegality.

   So while the *Epic* decision may deter some employment litigation, employers can expect to see increased litigation challenging the validity of arbitration agreements, and whether such "take it or leave it" agreements are enforceable.

   Employers with a multistate workforce must be particularly mindful of the nuances among the various state law requirements governing the enforceability of arbitration agreements and whether, for example, arbitration imposed on existing employees is supported by adequate consideration.

2. ***Mass (and costly) arbitration filings.*** A creative plaintiffs' bar has already waged mass arbitration filings against several companies such as Chipotle, Uber, Lyft, and Buffalo Wild Wings. More than 12,000 individual arbitration claims were reportedly filed against Uber in August 2018. Because most arbitration agreements require the company to pay the arbitration fee, the cost to initiate the individual arbitrations was believed to exceed $18 million. However, most of these cases generally arose after a collective action was conditionally certified, putative class member names were disclosed, and later proceedings resulted in enforcement of class or collective action waivers. While mass arbitration filings are difficult for plaintiff's counsel to organize, they can arise under unique procedural circumstances.

3. ***Challenges to the applicability of the FAA.*** Another recent Supreme Court decision in *New Prime Inc. v. Oliveira* reiterates that the FAA is not without limits. Section 1 of the FAA exempts from arbitration "contracts of employment of seamen, railroad employees, *or any other class of workers engaged in foreign or interstate commerce*." Although this latter clause has historically been construed to include transportation workers involved in interstate commerce, the possibility exists that the clause will be expanded to any employees engaged in interstate commerce — a standard readily met in today's e-commerce world.

4. ***Employee resistance.*** While many employers rushed to adopt arbitration agreements following *Epic*, a number of tech firms have been moving in the opposite direction, fueled largely by the #MeToo movement. Microsoft and Facebook have reportedly done away with mandatory arbitration of sexual harassment claims, and Google has allegedly eliminated arbitration agreements altogether. Last year, several large law firms faced opposition from incoming law clerks who criticized the firms' arbitration policies in social media; this prompted a number of law schools to send letters to more than 300 law firms asking about their policies. Many law firms ultimately withdrew their mandatory arbitration agreements. Workers in other sectors could follow suit, prompting companies to change their practices.

5. ***Legislative action.*** In February 2019, Democratic legislators introduced a bill aimed at banning mandatory arbitration agreements. The Forced Arbitration Injustice Repeal (FAIR) Act proposes to do away with mandatory arbitration agreements impacting employment, civil rights, consumer, and antitrust disputes altogether, and would eliminate class waivers in other arbitration agreements. Additionally, several states have passed legislation banning mandatory arbitration of sexual harassment claims. It remains to be seen whether those state laws will survive a preemption challenge in light of *Epic*.

Notwithstanding these challenges, the benefit of the class waiver protection afforded by *Epic* is significant and should be a considerable factor in deciding whether to adopt mandatory arbitration. ■

On Cybersecurity, Grab the Low-Hanging Fruit

SEC Tells Firms to Stop Missing the Basics on Cybersecurity

BY MICHAEL YAEGER

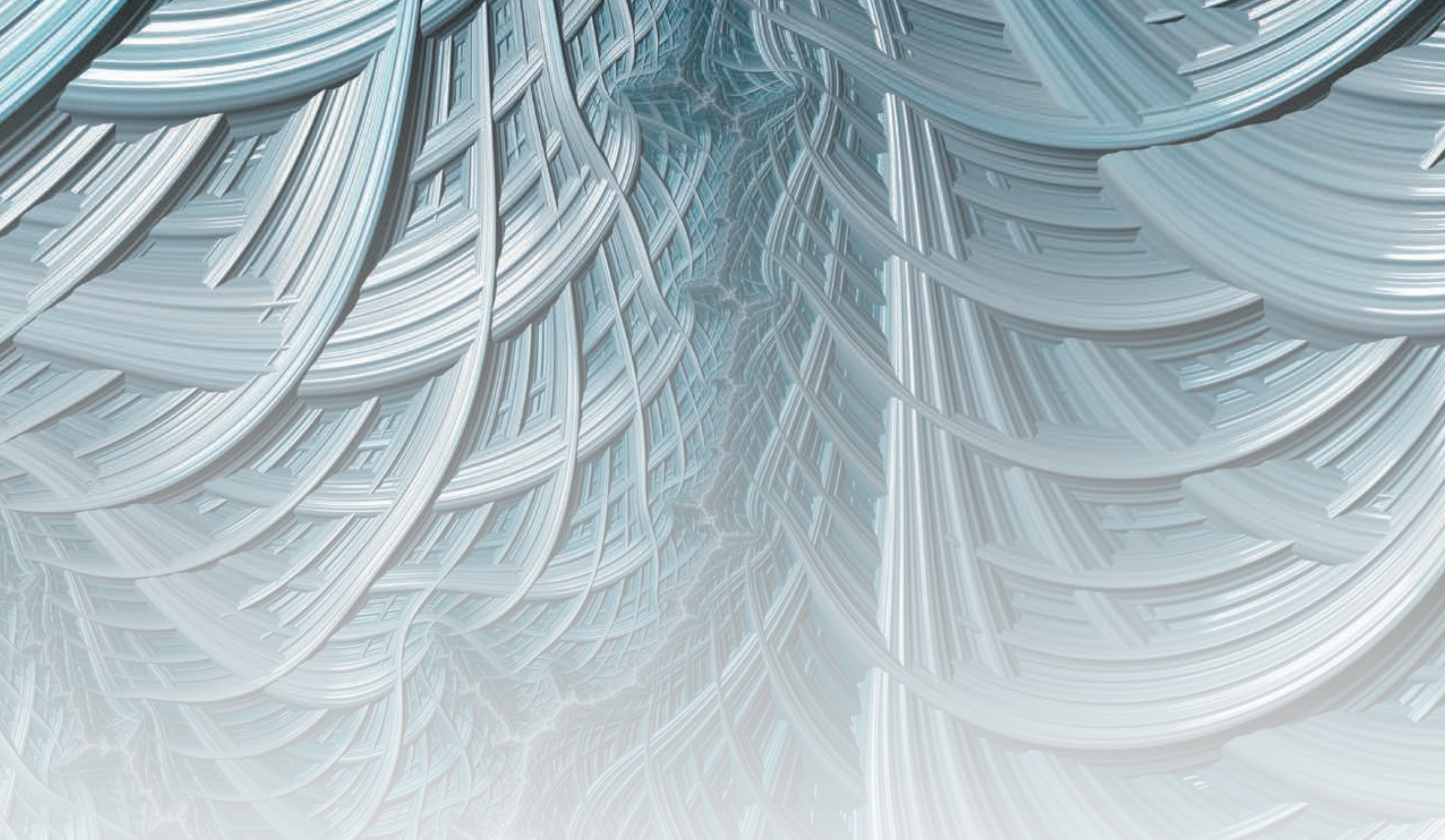
The SEC's Office of Compliance Inspections and Examinations (OCIE) reported in a recent Risk Alert that many investment advisers and broker-dealers are failing to comply with basic aspects of Regulation S-P, which requires registered firms to provide customers with privacy notices and to safeguard customers' records and information. The observed deficiencies are especially notable as they are basic flaws already discussed in previous SEC guidance; failure to correct them may lead to fines or even significant consequences in private suits by investors. Faced with such deficiencies, a court might conclude that a firm has not taken reasonable measures to safeguard customer information.

Regulation S-P requires that firms provide customers with initial notices regarding their privacy policies and practices when they sign up, with annual notices throughout the customer relationship, and with "opt-out" notices describing customers' right to forbid disclosure of nonpublic personal information to nonaffiliated third parties. But OCIE observed in recent examinations that many firms did not provide such notices, and that when they did, the notices did not always accurately reflect firms' policies and procedures.

OCIE also noted that firms failed to implement a host of basic policies and procedures designed to ensure the confidentiality and integrity of customer information. Deficiencies included:

- lack of policies and procedures to prevent employees from regularly sending unencrypted emails containing personally identifiable information (PII);
- lack of training on the use of encryption;
- failure to create an inventory identifying all systems on which the firm maintained customer PII;
- failure to revoke the system access rights of departed employees;
- contracts with outside vendors where the vendors did not agree to keep customers' PII confidential, even though such agreement was mandated by the firm's policies and procedures; and
- incident response plans that omitted "role assignments for implementing the plan, actions required to address a cybersecurity incident, and assessments of system vulnerabilities."

Especially because the SEC staff has now provided multiple warnings, such deficiencies deserve more attention. ■



Cryptocurrency Regulatory Complexities Multiply

BY MATTHEW KOHEN

Firms seeking to integrate digital assets into their business — including the sale of insurance or securities products and services — must grapple with the potential applicability of money transmission regulation that varies from state to state.

For example, in early 2019, a Florida state appellate court opinion in *State v. Espinoza* added to the growing regulatory mosaic affecting how individuals and businesses use bitcoin and other virtual currencies.

The appellate court ruled that the trial court incorrectly dismissed a case against Michell Espinoza, who was charged with operating an unlicensed money services business and money laundering. Espinoza was arrested after selling bitcoin to undercover law enforcement officers in exchange for U.S. dollars. In order to establish a money laundering violation, the undercover officers informed Espinoza that they had obtained the U.S. dollars being used to purchase the bitcoin via illegal activity.

The trial court originally dismissed the charges because, among other things, it concluded that bitcoin did not constitute money within the purview of Florida's money transmission and money laundering statutes. The appellate court disagreed, holding that bitcoin can be considered a medium of exchange that had monetary value and, as such, was a payment instrument as defined in Florida law.

Accordingly, the appellate court held that a person who transfers bitcoin to a third party in exchange for payment from that third party is engaging in money transmission under Florida law. A firm conducting such operations in Florida generally must obtain a license from the state Office of Financial Regulation.

Although the opinion lends further support to the proposition that bitcoin represents monetary value, it does little to resolve other questions about the scope of conduct that is considered money transmission. Even in Florida, therefore, firms seeking to buy, sell, or otherwise integrate digital assets into their business model may face uncertainties about whether a money transmission license is required. ■

Changes to the Patent Landscape for the Insurance and Financial Industries

BY ETHAN HORWITZ, GAIL PODOLSKY AND ALEX SILVERMAN

Changes in patents are afoot that will have a significant effect on the insurance and financial industries. Although business method patents have been the pariah of the patent industry for the past few years,

- The courts are starting to analyze these patents in greater detail and finding many more business methods to be patentable;
- The U.S. Patent and Trademark Office (USPTO) is adopting new rules for how to deal with applications for business method patents; and
- Bipartisan groups in Congress are studying what new legislation is needed to clarify what may or may not be patentable.

Historical Perspective

Patent law provides that patents are available for any "new and useful process, machine, manufacture, or composition of matter." Older cases held that patents were not available for laws of nature (such as gravity), natural phenomena (such as lightning), or abstract ideas (such as a method of bookkeeping). For many years — until the computer age — there was little controversy about what forms of invention were patentable (i.e., were patent-eligible subject matter). Realize that this is unrelated to whether an invention is novel or nonobvious.

Computers changed the assumptions about patentability and gave birth to the business method patent. Historically, a company could not patent an internal policy that if a customer called for a maintenance issue, any past due bills would be discussed first. However, one of the more lucrative business method patents was one claiming a computerized system for recognizing a customer call based on the phone number and transferring that call to the billing department if there were any overdue bills. Essentially the same policy, but with a computer performing the function, it was now a machine and patentable.

Around the time computers were becoming a way of life, the Federal Circuit endorsed business method patents in a case called *State Street*. But after *State Street*, these patents got out of hand — businesses and Congress were complaining that there were many frivolous business method patents, and that plaintiffs were using these patents to harm business. The Supreme Court, in a 2014 case called *Alice*, ruled that merely using a computer to perform a function did not make that computerized system patentable. With *Alice*, the pendulum had swung back against business method patents, and the courts and the USPTO started to strike down patent after patent that had any relationship to a business method patent. But like all pendulums, this one is beginning to gravitate to a more middle and reasonable ground.

Recent Court Cases

The courts are starting to analyze these patents before merely rejecting them. Specifically, the courts are looking closer into whether an invention uses an abstract idea in a patent-eligible way. The courts recognize that many inventions use the building blocks of abstract ideas. However, how those abstract ideas are used determines whether they are patentable. One case, *Data Engine v. Google*, provides a good example because the Federal Circuit found different claims in the same patent valid and invalid. The patent was directed to making complex three-dimensional spreadsheets more accessible and readable. The claims that were directed to tracking changes to spreadsheet data were held to be mere automation of a manual process and therefore not patentable. By contrast, the claims that were directed to a specific method of navigating through a three-dimensional spreadsheet by providing a highly intuitive, user-friendly interface were held patentable.

The basic difference was that one merely used the abstract idea in a way that could be done manually, and the other provided a solution to a problem that helped navigate the spreadsheets and could not be done manually. This more in-depth study of the invention is what can be expected in the future, and the lines between what is and is not patentable are not fully clear based on the existing case law.

USPTO Actions

The USPTO is also changing its standards for examining patents in this area. It established a two-part test based on *Alice* — first determine if the claim contains an abstract idea; if not, then the subject matter is patentable. If an abstract idea is found, however, then it must be determined if that abstract idea is incorporated into a practical application. If it is, then the subject matter is patentable. After *Alice*, business method claims evaluated under this test were largely deemed unpatentable.

But the USPTO issued revised guidelines in 2019, which reflected changes in the legal landscape so that more inventions would be considered as incorporating an abstract idea into a practical application. The USPTO has also set out various examples of what is and is not patentable, and while there is clearly a move to make more of these inventions patentable, there is still a lot of gray area. The art is often in drafting the patent to describe the invention in a way that is a practical application.

Congressional Initiatives

In addition, a bipartisan group in Congress is exploring changes in patent law to more clearly delineate what is and is not patentable. There are many proposals of how to phrase the new law, and no doubt the exact language will change significantly before anything is passed. If history is any guide, whatever the language, there will be significant litigation into its meaning.

The Landscape for Now

What these developments mean for insurance and other financial companies is that they once again need to worry about patents. With these developments, and those on the horizon, many business methods once eliminated from patent consideration are now back in the picture. Insurance and other financial companies will have to take this into consideration in the future.

Defensively, insurance and financial companies will have to be diligent in developing new products or processes to ensure they are not infringing. In most situations, a new product will not be the subject of another's patent. But back-office processing, methods of forecasting, methods of identifying and evaluating risk, and other systems will be at risk under these new patent rules. Business method patent litigation has been quiet recently, but with these new developments, it is likely to emerge once again.

Many plaintiffs brought questionable, and even ridiculous, claims to extract small early settlements. One plaintiff we dealt with sued more than 200 companies under very questionable patents. It leveraged the prospect of costly patent litigation and offered to settle for a fraction of that amount — it settled with most and amassed many millions of dollars doing this. After a client approached us to fight, we not only won, but also were able to recover attorneys' fees for filing a frivolous case. Nevertheless, this is the exception, and many plaintiffs will again sue using business method patents, especially given the lack of clarity in the rules.

Offensively, insurance and financial companies need to capitalize on the opening created by the new patent-eligibility rules. There are now opportunities to secure exclusive rights to a process or system that gives it a commercial advantage. These patents can be quite valuable in protecting a unique process or system that others may wish to copy. Getting patents can also be used defensively as counterclaims if the company is sued. While there is a tendency to believe that suits among competitors will not occur, the number of times we have been asked to represent a client who says "no one in our industry sues for patent infringement" cannot be counted.

In sum, change is coming — in fact, it is here — and insurance and financial companies will be affected by this change and need to plan for it. ■

Carlton Fields Successfully Defends Transamerica in Putative Class Action Involving Long-Term Care Insurance

BY JULIANNA MCCABE

In April 2019, a unanimous panel of the U.S. Court of Appeals for the Ninth Circuit issued its mandate affirming summary judgment in favor of Transamerica Life Insurance Co. in a putative class action involving long-term care insurance. Attorneys from Carlton Fields' National Class Actions Practice handled the case from inception through resolution of the appeal.

The plaintiff in the case sought to represent all insureds under long-term care insurance policies in the state of Washington. The plaintiff filed the lawsuit seeking nursing home benefits, despite residing in an assisted living facility that was not licensed as a nursing home, as required by the policy. The plaintiff argued that under various state laws and regulations, the court was required to rewrite the policy to eliminate the licensing requirement.

Transamerica removed the case from state to federal court in Seattle under the Class Action Fairness Act and sought summary judgment based on the plain language of the contract. In a hotly contested battle involving cross-motions for summary judgment and the plaintiff's motion for additional discovery, Chief Judge Ricardo S. Martinez of the U.S. District Court for the Western District of Washington granted summary judgment to Transamerica, denied any further discovery, and held that the plaintiff was not entitled to represent a class because he did not, himself, have a viable theory of liability.

The plaintiff appealed, with the support of a consumer advocacy group as amicus curiae, and the Ninth Circuit panel affirmed the district court in all respects.

The judgment and result on appeal were appropriate and significant wins for the industry. A negative result could have required a change in contract interpretation by insurers with similar long-term care insurance policies, threatened similar litigation for the industry as a whole, and likely driven up the cost of premiums for all policyholders. ■

NEWS & NOTES

Carlton Fields is an executive partner of the ACLI's Compliance & Legal Sections Annual Meeting on July 15-17 in Fort Lauderdale, FL. The conference features industry experts addressing topics pertinent to both compliance and legal executives. Shareholder **Irma Solares** will be a panelist on the panel "Litigation Update," providing an overview on recent litigation developments.

The firm was a sponsor of the National Association for Fixed Annuities (NAFA) Annuity Leadership Forum, held June 11-13 in Washington, D.C. Shareholder **Richard Choi** presented on a panel about best interest and hot topics in annuity regulation and litigation today.

Carlton Fields sponsored this year's Insured Retirement Institute ACTION19 conference, held May 15-17 in Washington, D.C.

- **Richard Choi** spoke on the topic of "The Long and Winding Road to a Variable Product Summary Prospectus."
- **Markham Leventhal** presented on a panel titled "'Howey' Doing in the World of Securities Regulation? Rulemaking, Examination, Enforcement, and Retirement Plan Litigation Developments."
- **Ed Zaharewicz** was a panelist for the product development session on fee-based annuities.

The firm released its eighth annual *Class Action Survey*, revealing a continuing rise in class action defense spending, driven by more matters per company facing these cases, and, collectively, more complex, high-risk, and bet-the-company matters than ever reported in past surveys. The survey is available at www.ClassActionSurvey.com

Shareholder **Markham Leventhal** was selected for inclusion in the 2019 issue of Washington, D.C., *Super Lawyers*. Only 5 percent of Washington, D.C., attorneys earn a spot on the list each year.

Carlton Fields welcomes the following attorneys to the firm: Shareholders **David Gay** (bankruptcy and creditors' rights, Miami), **Edward Kuchinski** (construction, Tampa), and **Clark Lackert** (intellectual property, New York); Of Counsel **Andrew Hinkes** (blockchain and digital currency, Miami), **David Karp** (appellate and trial support, Tampa), and **Robin Leavengood** (construction, Tampa); and Associates **Nancy Conicella** (real estate and commercial finance, Orlando), **Laura Jo Lieffers** (construction, Tampa), **Enrique Miranda** (health care, Tampa), and **Abigail Preissler** (real estate and commercial finance, Hartford).

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