LIFE, ANNUITY, AND RETIREMENT SOLUTIONS INDUSTRY

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EXPECTFOCUS®

LEGAL ISSUES AND DEVELOPMENTS FROM CARLTON FIELDS

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EXPECTFOCUS®

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EXPECTFOCUS® is a review of developments in the life, annuity, and retirement solutions industry, provided on a complimentary basis to clients and friends of Carlton Fields.

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SEC Takes ESG Disclosure Plunge

An Ocean of Issues Swirls

BY GARY COHEN

It comes as no surprise that the SEC has placed environmental, social, and governance matters on its regulatory calendar, even though the SEC says it's doing so for the "first time."

An SEC announcement of Chair Gary Gensler's rulemaking agenda states that the Division of Investment Management "is considering recommending that the Commission propose requirements for investment companies and investment advisers related to environmental, social and governance (ESG) factors, including ESG claims and related disclosures."

The announcement also states that the Division of Corporation Finance "is considering recommending that the Commission propose rule amendments to enhance registrant disclosures regarding issuers' climate-related risks and opportunities" and "human capital management."

The SEC has been busy receiving input and recommendations from at least five separate in-house sources: the Investor Advocate, the Investor Advisory Committee, the Asset Management Advisory Committee, the Climate and ESG Task Force in the Division of Enforcement, and the senior policy adviser for climate and ESG.

Moreover, in response to an invitation from then-acting Chair Allison Herren Lee, the SEC has received 5,781 written comments, including submissions from the Investment Company Institute and the American Council of Life Insurers. Individual commissioners or staff members have met with 50 organizations.

The SEC's Investor Advocate has reported to Congress that there are two problems with how the traditional materiality test for ESG disclosure is functioning. First, "information provided by companies tends to vary in quality, and it is not presented in a standard format that enables comparisons between companies." Second, disclosure may not reveal the practice of "greenwashing," which is "the practice of making misleading claims regarding companies' or funds' ESG credentials in order to draw the interest of investors who place value in ESG matters."

Gensler has explained that he's looking for rules that will assure "truth in advertising." He says that he wants more transparency and comparability where there is "currently a huge range of what asset managers might mean by certain terms or what criteria they use" in terms of claiming "sustainability-related investing." He also says that the rules governing fund names focus on "investment types, as distinguished from investment strategies" and asks "whether that distinction ... is still relevant today."

SEC Deep-Sixes Offering Integration Test

New Rules Replace the Old Five Factors

BY TOM LAUERMAN

SEC rule changes effective in March of this year have replaced the patchwork of guidance and rules developed over many decades to determine when securities offerings should be "integrated" with one another when deciding whether one or both offerings meet the requirements for an exemption under the Securities Act of 1933. Questions regarding whether such integration is required arise often in connection with privately offered investment funds and privately offered variable insurance products.

Now, major revisions to Rule 152 under the act have effectively superseded the SEC's "five-factor test" that has underpinned the integration analysis for more than five decades. Instead, the basic principle under Rule 152 is now that offerings will not be integrated if each offering either complies with the registration requirements of the act or relies on an exemption from registration that is available for the particular offering. The rule also provides further detail on how that basic principle is to be applied to avoid:

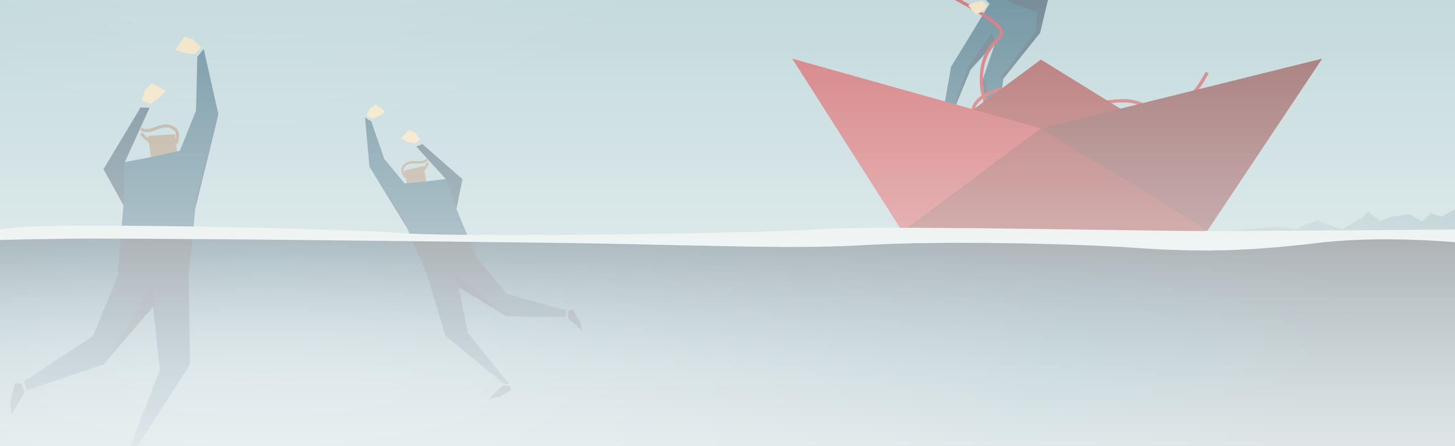
- Integration of an exempt offering under which "general solicitation" is prohibited with one or more offerings under which general solicitation is permitted; or
- Integration of an exempt offering under which general solicitation is permitted with one or more other exempt offerings permitting such general solicitation.

The rule also sets forth a number of "safe harbors" under which, irrespective of the above basic principle, there will be no integration. These safe harbors include that, generally:

- If the commencement of one offering is at least 30 days after the termination of another offering, the two offerings will not be integrated.
- Offshore offers and sales made in reliance on Regulation S under the act will not be integrated with other offerings.
- An offering for which a registration statement has been filed will not be integrated with a previously completed or terminated offering under which general solicitation (i) was not permitted or (ii) was permitted only of "qualified institutional buyers" or "institutional accredited investors."
- An exempt offering under which general solicitation is permitted will not be integrated with a previously terminated or completed offering.

Among other things, Rule 152 now also contains detailed provisions concerning when an offering will be deemed to commence or end for integration purposes of the rule. The SEC release adopting the rule's recent changes contains much explanatory material that may be useful to practitioners in applying the rule's provisions.

Although the changes to Rule 152 are a welcome simplification, codification, and clarification, they do not remove all uncertainties. In this connection, similar to a number of other SEC exemptive rules, Rule 152 now enigmatically provides that it cannot be relied upon to avoid integration of any transactions or series of transactions that, although in technical compliance with the rule, are part of a plan or scheme to evade the act's registration requirements.



The NAIC's New E-Commerce Class

BY ANN BLACK AND JAMIE BIGAYER

A new E-Commerce (EX) Working Group (E-Commerce WG) class has been added to the NAIC course catalog to learn how to expand the use of technology, specifically e-signature, e-delivery, e-notary, and e-education, in insurance. The group was charged to "[e]xamine e-commerce laws and regulations; survey states regarding federal Uniform Electronic Transactions Act (UETA) exceptions; and work toward meaningful, unified recommendations."

In response to the COVID-19 pandemic, many states granted regulatory relief or accommodations concerning the use of electronic technologies. As a result, the insurance industry and regulators learned these innovations could be beneficial to consumers and the industry if they were made permanent.

The first homework assignment for the E-Commerce WG is to determine whether there are barriers to accomplishing that goal, for example the lack of uniformity in the state adoption and implementation of UETA. The E-Commerce WG is developing a survey to (i) understand the landscape of state adoption of UETA and related laws; (ii) identify any gaps in the adoption or implementation of UETA; and (iii) identify the laws or regulations temporarily activated or suspended to facilitate e-commerce, including whether such activations and suspensions have since expired or been rescinded.

After the E-Commerce WG submits its first assignment, its next task will be to "examine whether a model bulletin would be appropriate for addressing some of the identified issues and will draft a proposed bulletin if determined appropriate."

Possible SEC Proxy/Whistleblower Rule U-Turns?

Could Reverse Trump-Era Actions

BY GARY COHEN

The SEC, in an unusual move, is reconsidering certain significant proxy rules that it adopted just last year.

An SEC announcement of Chair Gary Gensler's rulemaking agenda states that the Division of Corporation Finance "is considering recommending that the Commission propose rule amendments regarding shareholder proposals" and "governing proxy voting advice."

The announcement can be read as signaling Gensler's intent to reverse or limit the 2020 rules that the SEC adopted under his predecessor Jay Clayton during the Trump administration. The rules raise the eligibility requirements for shareholders submitting proposals and impose conditions on firms providing proxy voting advice.

The Commission adopted the rules over the objections of the two Democratic commissioners, Allison Herren Lee and Caroline Crenshaw. The SEC's two Republican commissioners, Hester Peirce and Elad Roisman, have reacted negatively to the chairman's agenda, calling it a "regrettable" "game of seesaw with our rulebook." They said that the listing was "reopening large swathes of work that was just completed without new evidence to warrant reopening" and "undermin[ing] the Commission's reputation as a steady regulatory hand."

Calls to revisit last year's proxy revisions have come from several sources. For example, the SEC's Investor Advocate has argued that the rule on shareholder proposals should be "overturned or reversed" by Congress or the new SEC leadership. In an extraordinary accusation, the Investor Advocate has reported to Congress that the SEC's adoption was "in contravention" of the Securities Exchange Act and "at the very least, the spirit of the Administrative Procedure Act." The Investor Advocate also told Congress that "the economic analysis in this rulemaking was fundamentally flawed" and "in contravention of the Commission's internal policies for full and objective economic analysis."

Moreover, the SEC's Division of Corporation Finance has taken the remarkable step of announcing that "it will not recommend enforcement action to the Commission ... during the period in which the Commission is considering further regulatory action" regarding the rules on proxy advisory firms. It is highly unusual for the SEC staff to announce this type of sweeping no-action position concerning enforcement of a major rule that the Commission has recently adopted and no court has invalidated.

The Commission is following a similar controversial path in reconsidering whistleblower rules that it adopted last year. Gensler's rulemaking agenda states that the Commission "is considering additional amendments to the rules governing the [Commission's] Whistleblower Program." Gensler has explained, in a recent public statement, that "[v]arious members of the whistleblower community, as well as Commissioners Lee and Crenshaw, have expressed concern that two of these amendments could discourage whistleblowers from coming forward." The Commission then issued a release announcing that, "[w]hile the staff is preparing and the Commission is considering potential additional rulemaking," the Commission will be following "interim procedures" that effectively reestablish the original whistleblower rules.

Commissioners Peirce and Roisman objected, in a public statement, that "[t]his effectively nullifies standing Commission rules under the guise of changes to 'agency procedures.'" They argued that "[a]bandonment of duly-adopted rules without notice and request for comment raises the prospect that the rules that the Commission adopts in compliance with the Administrative Procedure Act may be interim at best, and transitory at worst." They called Gensler's course of action "unwise" and continuing "a troubling and counterproductive precedent."

Stopping GameStop Games

Regulators Eye Payment for Order Flow

BY JUSTIN CHRETIEN

The SEC and FINRA have been busy of late in efforts to address issues associated with payment for order flow (PFOF) and the consequences of the trading halt in GameStop shares last January. PFOF has potentially significant implications not only for broker-dealers but also for investment managers and advisers.

The SEC defines PFOF to encompass "a wide variety of cash or in-kind compensation structures that a broker may receive for directing its customers' orders to a particular broker-dealer or trading venue." As such, PFOF may provide an economic incentive that can potentially influence a firm's order handling, creating a potential conflict of interest with the firm's best execution obligations. Although the receipt of PFOF does not constitute a per se violation of a firm's best execution obligations, it does raise concerns.

In November 2015, FINRA published Regulatory Notice 15-46 to reiterate the best execution obligations of member firms in light of increasingly automated markets and advances in trading technology, including PFOF.

In response to GameStop, in June 2021, FINRA published Regulatory Notice 21-23 specifically reminding firms of their best execution obligations in the context of PFOF. In particular, firms were reminded that under FINRA's best execution rule (Rule 5310), PFOF may not be considered in determining the best market for a subject security but may be considered as part of the firm's regular and rigorous review of execution quality, as well as any price improvement received.

Other rules require disclosure of PFOF arrangements to customers. Under the Securities Exchange Act of 1934, firms must provide written notification to customers at or before completion of a transaction that PFOF is being received and that the source and nature of the compensation will be furnished upon request. Firms are further required by Regulation National Market System to make publicly available each calendar quarter a report on the member's routing practices to include the aggregate amount of any PFOF received, both as a dollar amount and per share, and a description of any arrangement for PFOF.

Reviewing the recent congressional testimony of SEC Chair Gary Gensler and FINRA CEO Robert Cook following GameStop, it is clear that both are committed to adapting the existing regulatory regime to advances in technology and new business models.

This commitment means that, even after GameStop, there will not likely be significant limitations or prohibitions against PFOF, at least in the near term. Instead, the regulators will continue to focus on enforcing the best execution rule under the PFOF model, which includes a requirement for conducting regular and rigorous reviews of execution quality across competing markets. The disclosure rules also may be updated to require immediate post-trade information regarding PFOF and any price improvement received.

For more detail about this important subject, please see our recent article "Regulators Consider Payment for Order Flow and the Gamification of Trading After GameStop."

Diving Into IoT Data? Here Are Some Privacy Considerations

BY ANN BLACK AND PATRICIA CARREIRO

Many insurers contemplate using data from internet-connected devices, including wearables, for a deep dive into wearers' lifestyles and invaluable insights for automated underwriting. Before diving into the deep end, there are numerous privacy considerations. To ensure your IoT data does not plunge you into trouble:

1. Adjust your data map.
    a. Begin by drawing out all the actors that will collect, use, access, transfer, or disclose consumer data.
    b. Write in what type of data each of them will collect, use, access, transfer, or disclose.
    c. Draw arrows to show the flow of data between these actors and add the purposes for which each arrow/"data flow" occurs.
    d. To make sure you have captured everything, practice running different scenarios through your data map (consumer applies through X, application is approved, application is denied, etc.).
    e. Be sure to get each relevant department within your organization's approval that the data map is correct and complete. Ask questions and test answers.
2. Make sure your contracts with third parties won't sink you.
    a. Contracts with third parties with whom you will share data (or vice versa) should align with the data map. Ensure your contracts appropriately reflect what data the third party will receive, who is responsible for obligations associated with that data (e.g., who is responsible for providing X notice or securing Y consent), and what the third party can and cannot do with that data.
    b. Evaluate each sharing as a potential "sale" under the CCPA. Ways to avoid the CCPA's "sale" obligations include:
        i. *GLBA or CalFIPA Data*. Personal information "collected, processed, sold, or disclosed pursuant to" the Gramm-Leach-Bliley Act (GLBA) or the California Financial Information Privacy Act (CalFIPA) is exempt from most of the CCPA. For other data, a separate exemption is needed.
        ii. *Service Providers*. If the data might not be GLBA or CalFIPA data, the next best "out" of the CCPA's "selling" obligations is sharing with a "service provider." To qualify as a "service provider," however, specific contractual terms must be included in the insurer third-party contract.
    c. Don't forget contractual "floaties" requiring your third-party partners to appropriately protect the data, notify you in case of an actual or suspected breach, indemnify you in case of such breaches, process consumer requests, and assist in demonstrating compliance to regulators. Also, given privacy laws' springboard of activity, including the NAIC's Working Group, seek a commitment from your partners to comply with new legal requirements.
3. Watch out for the deep end, as privacy obligations in your third-party contracts may be submersed in hyperlinks included in the contract or their standard terms of use. Understand these obligations and how they can change with or without notice to you. Consider whether your partner requires consumers to complete a particular form, whether you are required to specifically disclose that partner and link to its terms of use in your notices, whether you are agreeing to comply with an entirely different privacy law that you are not otherwise subject to, etc.
4. As with any new data, update your privacy notices and authorizations to cover this new data collection and its associated uses, sharing(s), and purpose(s). Multiple federal and state laws are likely to govern the notices, consents, registrations, and processes required. As the recently filed class action suits against Lemonade reflect, your notices must accurately reflect your practices.

With proper analysis and planning, your program could win gold.

Regulation Best Interest and Form CRS

Examinations and Enforcement Heat Up

BY ANN FURMAN

Not long after the SEC adopted Regulation Best Interest (Reg BI) and the related Form CRS Relationship Summary in June 2019, the SEC Office of Compliance Inspections and Examinations (now the Division of Examinations) issued two risk alerts outlining its examination focus on compliance with Reg BI and Form CRS. The Division of Examinations staff updated its Reg BI examination guidance in December 2020 for examinations beginning in January 2021.

For its part, FINRA reviewed several broker-dealers in late 2019 and 2020 to assess preparedness for Reg BI and Form CRS. FINRA published the results of its assessment on its website and also prepared a Reg BI and Form CRS firm checklist and other compliance guidance.

As usual, broker-dealers' sales of variable insurance products have been one area of regulators' concern.

Reg BI

When making a recommendation, a broker-dealer and its associated persons are required to act in a retail customer's best interest and cannot place its own interests ahead of the customer's interests.

The SEC conducted initial examinations of broker-dealers in 2020 to assess processes relied on to comply with Reg BI. The SEC has expanded the scope of its examinations in 2021 to assess the implementation of broker-dealers' policies and procedures designed to address the four components of Reg BI: disclosure, care, conflict of interest, and compliance. The 2021 exams also have focused on the need for broker-dealers to consider alternatives to any product they are recommending, including cost considerations. Issues arising when making recommendations to new customers, recommending complex products, and assessing conflicts of interest also have taken center court.

Form CRS

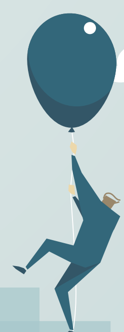
Broker-dealers and registered investment advisers are required to deliver to retail customers a relationship summary that provides information about the firm. Firms also must file Form CRS and post it on their public website.

In announcing its 2021 examination priorities, the SEC Division of Examinations noted that even though "over 13,000" Form CRS filings were made, it sent notices to "hundreds" of firms that had not timely filed Form CRS.

For those firms that received multiple late filing warnings, the SEC took swift enforcement action. In late July, the SEC announced 27 settled enforcement actions involving late Form CRS filings by 21 investment advisers and six broker-dealers. The SEC orders alleged willful violations, with civil money penalties ranging from $10,000 to $97,523. The orders imposed the largest penalties on those investment advisers with the greatest amount of regulatory assets under management. The firms did not admit or deny the findings.

What's Next?

As of the publication of this article, no reported Reg BI enforcement actions appear on the SEC or FINRA websites. But just as SEC warnings of late Form CRS filings led to enforcement actions, SEC and/or FINRA enforcement actions will likely follow from the current Reg BI and Form CRS focused examinations.



Insurers Need to Do Their Homework

Review of the Use of Data, Algorithms, and Predictive Models

BY ANN BLACK AND JAMIE BIGAYER

On July 6, 2021, the governor of Colorado signed Senate Bill 21-169 prohibiting insurers' use of external consumer data and information sources (external data), as well as algorithms and predictive models using external data (technology) in a way that unfairly discriminates based on race, color, national or ethnic origin, religion, sex, sexual orientation, disability, gender identity, or gender expression (protected status). Bill 21-169 notes that while these tools may simplify and expedite certain insurance practices, "the accuracy and reliability of external consumer data and information sources can vary greatly, and some algorithms and predictive models may lack a sufficient rationale for use in insurance practices." New section 10-3-1104.9 becomes effective on September 6, 2021, and any rules adopted by the insurance commissioner may not be effective before January 1, 2023.

Section 10-3-1104.9 requires the commissioner to adopt rules based on the different insurance types and insurance practices, which is defined as "marketing, underwriting, pricing, utilization management, reimbursement methodologies, and claims management in the transaction of insurance." To do so, the commissioner is required to call on stakeholders and to consider factors and processes relevant to each type of insurance.

> This means insurers must start their homework early so they can be ready to explain to the commissioner what data they use; from whom the data is obtained; how it is used, including whether it is used as part of an algorithm or predictive model; and whether the use of the data results in unfair discrimination as defined in section 10-3-1104.9(8)(e).

Required Rulemaking Under Section 10-3-1104.9

From the stakeholder information, the commissioner is required to adopt rules imposing reporting and governance obligations on insurers.

- **Reporting Rules** – These rules must seek information on (i) an insurer's use of external data in the development and implementation of technology; (ii) the manner in which the insurer uses external data; and (iii) the manner in which the insurer uses technology. The information is to be reported by type of insurance and insurance practice.
- **Governance Rules** – These rules must require insurers to (i) establish and maintain a risk management framework reasonably designed to determine, to the extent practicable, whether the insurer's use of external data and technology unfairly discriminates against a protected status; (ii) assess the risk management framework; and (iii) obtain officer attestations as to the implementation of the risk management framework.

In adopting the required rules, the commissioner must (i) consider the impact of any rules on the solvency of insurers; (ii) provide a reasonable time for insurers to remedy any unfair discrimination impact of any employed technology; and (iii) provide a means by which insurers can use external data and technology that the insurance division has found not to be unfairly discriminatory.

Questions Raised by Section 10-3-1104.9

As part of the rulemaking process, insurers may want to raise their hands to ask questions on section 10-3-1104.9. Some questions include:

What is unfair discrimination?

In response to industry concerns regarding the definition of unfair discrimination, section 10-3-1104.9(8)(e) imposes a three-prong test:

- The use of external data or technology has a correlation to a protected status;
- The correlation results in a disproportionately negative outcome for such protected status; and
- The negative outcome exceeds the reasonable correlation to the underlying insurance practice, including losses and costs for underwriting.

To better understand this three-prong test, insurers at the stakeholder meetings should seek clarification. For example:

- How is the correlation between the use of the external data or technology and the protected status determined?
- How can an insurer test for the correlation, when section 10-3-1104.9(7)(a) makes clear that insurers are not required to collect information regarding protected status from applicants or policyholders? At the NAIC Special (EX) Committee on Race and Insurance during the 2021 NAIC Summer National Meeting, Colorado Commissioner Michael Conway noted that insurers do not need to collect specific data on race to be able to test for discriminatory outcomes, and Colorado will expect insurers to do such testing.
- How is a negative outcome on protected status determined and then quantified to determine if it exceeds a reasonable correlation?
- What is a reasonable correlation to determine what exceeds such correlation?

What is "to the extent practicable"?

An insurer's risk management framework will be required to be reasonably designed to determine, to the extent practicable, whether the insurer's use of external data and technology unfairly discriminates against a protected status. The terminology "to the extent practicable" was added in response to insurer concerns that they may not have the tools available to design the risk management framework. As the commissioner considers rulemaking, insurers may wish to ask whether "to the extent practicable" will take into account:

- The size of the insurer or the amount of business for a particular type of insurance that the insurer conducts.
- The fact that the insurer does not have the information to assess whether third-party vendor technology uses external data. And what happens if the third-party vendors refuse to share the information.

What is meant by algorithm?

Section 10-3-1104.9(8)(a) defines an algorithm as "a computational or machine learning process that informs human decision making in insurance practices." However, this broad definition leaves insurers to wonder whether "algorithm" would be interpreted to include even the use of simple computational programs such as Excel or other automation tools in connection with traditional underwriting. How far does the definition go?

What is external data?

Section 10-3-1104.9(8)(b)(I) defines external data as “a data or an information source that is used by an insurer to supplement traditional underwriting or other insurance practices or to establish lifestyle indicators that are used in insurance practices.” Section (8)(b)(I) gives the following examples: credit scores, social media habits, locations, purchasing habits, homeownership, educational attainment, occupation, licensures, civil judgments, and court records. However, many of these data points and other “lifestyle indicators” are obtained directly from the consumer as part of the application. Before the final exam, insurers might want to attend office hours to understand:

- Is information acquired in an application considered external data?
- Does such information become external data if it is used in an algorithm or predictive model?

What is meant by traditional underwriting?

Section 10-3-1104.9(7)(b)(II) and (IV) note that insurers are not required to test “traditional underwriting factors being used for the exclusive purpose of determining insurable interest or eligibility for coverage” or “longstanding and well-established common industry practices in settling claims or traditional underwriting practices” unless they are included in the insurer’s testing of its use of technology. But the following questions remain:

- What is meant by traditional underwriting factors and traditional underwriting practices? Are traditional factors and practices in an electronic medium or process now considered nontraditional?
- If traditional underwriting factors and practices are lumped in with an insurer’s use of technology, what is really exempt from having to be tested?

How Insurers Can Start Preparing for Class

- Begin to inventory what data is used, from whom the data is obtained, and how it is used, including whether it is used as part of an algorithm or predictive model, for each type of insurance the insurer issues and for each insurance practice where data is used. This includes seeking information from the insurer’s marketing, product design, underwriting, administrative services, claims, and fraud units. Insurers should take a broad view of data, algorithms, and predictive models to ensure everything that might be scrutinized by Colorado is considered.
- Inform the insurer’s marketing, product design, underwriting, administrative services, claims, and fraud units that subject matter experts from different business units will be needed for consultation as the Colorado insurance department holds stakeholder meetings and in developing governance around the use of data, algorithms, and predictive models.
- Review third-party contracts to determine what rights the insurer has (i) to obtain information about the data being used and the construction and operation of any algorithms and predictive models and (ii) to require the cooperation of the third party in the face of a regulatory review. Additionally, these rights and obligations should be incorporated into any new third-party contracts.
- Begin to outline a plan for satisfying the reporting and governance rules outlined above. This includes determining how the various business units will coordinate to compile the required information to be reported, as well as how each business unit will participate in and be responsible for the ongoing requirements of the risk management framework to be developed.

NAIC Illustration Work Stagnates in the Dog Days of Summer

BY ANN BLACK AND JAMIE BIGAYER

The NAIC groups working on illustration issues reported little activity at the 2021 NAIC Summer National Meeting.

The Life Insurance Illustration Issues (A) Working Group's (Life Illustration WG) charge has been to promote consumer readability and understandability of the life insurance disclosures made to consumers. For the past five years, the Life Illustration WG has been working on creating a new term policy overview document and debating whether to change the delivery timing of the disclosures required by the Life Insurance Disclosure Model Regulation. The Life Illustration WG paused over the summer to seek guidance on whether it should move forward with its work, as the group has not been able to reach a consensus.

At the National Meeting, the A Committee assigned the Life Illustration WG to draft a summary of the group's work completed thus far. This report would be reviewed at the 2021 NAIC Fall National Meeting to be used in deciding whether the Life Illustration WG should carry on or scrap its work entirely.

After the adoption of revisions to Actuarial Guideline 49-A (AG 49-A), the IUL Illustration (A) Subgroup (IUL Subgroup) was charged to (i) monitor the results and practices of IUL illustrations following the implementation of AG 49-A and (ii) review the current regulatory framework and provide recommendations for any necessary changes to the Life Insurance Illustrations Model Regulation (#582).

The IUL Subgroup is researching market developments following the adoption of AG 49-A. However, the work appears to be moving in fits and starts as the IUL Subgroup has not met since the Spring National Meeting, and while it is expected to meet before the Fall National Meeting to review the research, no date has been set.

Annuity Litigation Roundup

BY DIMITRIJE CANIC AND BROOKE PATTERSON

Court Emphasizes Disclosure Substance Over Form

A recent decision in *Nofsinger v. Jackson National Life Insurance Co.* shut down a putative class action in which the plaintiff alleged she surrendered her annuity contract after receiving a deceptive letter regarding her contract options from Jackson National and was then charged an improper surrender charge.

In *Nofsinger*, the plaintiff purchased a dual fund annuity contract from Jackson National as a supplemental retirement plan vehicle for teachers in 1991. A dual fund annuity differs from a traditional annuity in that it accrues at two different values: a cash surrender value and an accumulated value. A policyholder can withdraw either the partial or full amount of the cash surrender value at any time before the maturity date. However, to collect the accumulated value, rather than the cash surrender value, the policyholder must wait until the annuity's maturity date and then receive distributions over a minimum 60-month period.

In 2017, Jackson National sent the plaintiff a letter informing her that her annuity's maturity date was approaching and requested that she select an option for receiving annuity proceeds. The letter offered four different options, including a lump sum payout, which was defined as a partial or full liquidation. At the time, the accumulated value of her annuity was $104,000, and the cash surrender value was $86,000. The plaintiff selected the lump sum option allegedly believing that she would receive the full accumulated value of her annuity. Jackson National subsequently confirmed the plaintiff's request and paid her the cash surrender value of $86 thousand, referring to the difference as a "surrender charge." The plaintiff brought suit on behalf of herself and a putative class of individuals who received this type of letter from Jackson National and was subsequently assessed a "surrender charge" — a term not included in the annuity contract — asserting a variety of common law and statutory claims.

Jackson National moved for summary judgment on the breach of contract and violations of Illinois consumer fraud act claims contending that these claims failed as a matter of law. The court agreed. The court noted that the use of the term "surrender charge" in the Jackson National disbursement letter did not establish a breach of contract. The court explained that regardless of the terminology used, Jackson National performed properly under the terms of the annuity and paid the plaintiff exactly what she was entitled to receive when she selected the lump sum payout. The court noted that the "surrender charge" was simply the difference between the accumulated value and the cash surrender value and these amounts had been shown to the plaintiff on every statement throughout the life of the annuity.

With respect to the Illinois consumer fraud act claim, the court held that there was nothing deceptive in the Jackson National letter and nothing ambiguous about the term "lump sum payout," which could be discerned from the annuity and surrender letter and was clearly an alternative to receiving an annuity payment over time. The court also rejected the plaintiff's argument that the reference to a "surrender charge" was really the imposition of a new fee, noting that it was simply the difference between the accumulated and cash surrender values and not some new or additional charge.

The court also denied the plaintiff's motion for class certification because both the class and subclass rested on the surrender charge theory, which failed as a matter of law. The court held that "no class member could sustain a cognizable surrender charge claim based on the legal theories put forward," thus ending the plaintiff's class aspirations.

In *Williams v. National Western Life Insurance Co.*, a California appellate court recently addressed several important questions involving the actions of wayward insurance brokers and the corresponding duties of insurance companies.

Seeking to update his trust and estate plan, plaintiff Williams met with Pantaleoni, an independent insurance agent. Pantaleoni had Williams sign a blank check and additional documents, which Williams thought related to the trust. Unbeknownst to Williams, the documents included a National Western Life Insurance Co. annuity application. Although Williams signed the application, he did not fill out any information. Once Pantaleoni delivered the annuity, Williams canceled the annuity within the free look period. Pantaleoni thereupon

had Williams sign, again without his knowledge, another annuity application and two letters rescinding the cancellation of the annuity. Williams ultimately surrendered the annuity and received the cash value.

Thereafter, Williams sued Pantaleoni and National Western for elder financial abuse, negligence per se, fraud, and breach of fiduciary duty. Williams alleged that National Western knew or should have known of Pantaleoni's prior misconduct, which included a Department of Insurance action and restricted license, multiple bankruptcy filings, lack of errors and omissions insurance, using a legal services company to sell insurance products, and that National Western failed to investigate Pantaleoni's misconduct. The case proceeded to trial, with judgment entered against National Western.

Agent or Independent Contractor?

National Western filed post-trial motions, arguing that Pantaleoni was not National Western's agent for the transactions with Williams, which were denied. On appeal, the judgment against National Western was reversed.

The appellate court held that Pantaleoni's relationship to National Western was that of an independent contractor, that Pantaleoni had no authority to bind National Western, and that National Western had no duty to supervise Pantaleoni.

Duty of Good Faith and Fair Dealing; Negligence?

The court rejected Williams' argument that National Western had a statutory duty of good faith and fair dealing under the California Insurance Code, as the statute did not create a private right of action. The court also rejected the argument that the code's suitability requirements created a duty of care for a negligence claim. The opinion emphasized that an insurer has the right to rely on the answers provided by an insured in an insurance application, including suitability information.

Additionally, the court stated that a negligence claim could not be based on a prior settlement between National Western and the California insurance commissioner, as the settlement was not an admission of truth, and Williams could not enforce the settlement agreement as a nonparty.

Elder Abuse?

On the elder financial abuse claim, the appellate court held that simply accepting the premium and issuing the annuity, or processing the surrender request, was not evidence that National Western knew or should have known about Pantaleoni's fraudulent conduct. Further, National Western, as an insurance company, was not a mandated reporting entity under the applicable elder financial abuse statute and did not have a duty to investigate the transactions.

State Law Steers STOLI Cases

Drives Federal Court Outcomes

BY ELISE HAVERMAN

We previously reported in detail on developments in the case law and legislation addressing stranger-originated life insurance (STOLI) policies. *See* "New Jersey Springs Into Action: New Bill to Ban STOLI Policies" and "New Jersey Enacts Anti-STOLI Law," *Expect Focus – Life, Annuity, and Retirement Solutions*. In two recent decisions, the Second and Eleventh Circuit Courts of Appeal chimed in on the validity of STOLI policies.

In *Lincoln National Life Insurance Co. v. Inzlicht-Sprei*, the Second Circuit rejected a claimant's argument that he was entitled to his mother's insurance policy proceeds. Under New York insurance law, a person may procure an insurance policy on his or her own life and transfer it to someone without an insurable interest in that life, even where the policy was obtained for just such a purpose. The insured's decision, however, must be on the insured's own initiative and be free from nefarious influence or coercion. The Second Circuit found that the claimant had failed to raise a genuine issue of material fact as to whether his mother had been induced to take out the policy by nefarious influence or coercion, especially in light of his statement that his mother had proposed the idea to purchase and sell an insurance policy on her life. The court thus affirmed the district court's decision that a later purchaser of the policy was entitled to its proceeds.

In *Estate of Malkin v. Wells Fargo Bank, N.A.*, the Eleventh Circuit considered whether a 2006 policy on Malkin's life was, under controlling Delaware law, a prohibited STOLI policy procured or effected without an insurable interest. The policy at issue was orchestrated by, funded by, and transferred among a group of entities that were in the business of non-recourse premium financing of life insurance policies and targeted healthy seniors with excess wealth who wanted to make money off of their "life insurance capacity." The court concluded that the circumstances under which the policy was issued showed it was not purchased for lawful insurance purposes. Malkin did not procure the policy and never paid any of the premiums; rather, the policy was obtained through a power of attorney, and paid for, by unrelated third-party entities. Malkin was simply an instrumentality used to procure a policy for which there was no insurable interest. The court, accordingly, affirmed the district court's determination that Malkin's policy was an illegal STOLI policy, void under Delaware law.

The Eleventh Circuit, however, declined to affirm the district court's ruling that Malkin's estate was entitled to the policy's proceeds of $4 million. Berkshire Hathaway received the proceeds when Malkin died in 2014 after acquiring the policy in 2013. Berkshire argued it was a bona fide purchaser under Delaware's version of the Uniform Commercial Code. The district court held that allowing UCC-based defenses would gut the purpose and effectiveness of the insurable interest provision of Delaware's insurance code, which takes no notice of the UCC and makes no exception for bona fide purchasers. Based on the lack of precedential authority on whether UCC-based defenses can be asserted in this context, the Eleventh Circuit certified the question to the Delaware Supreme Court along with the question whether an investor can recover the premiums it paid on a void policy. Stay tuned.

The Three R's of LTC Insurance and Wellness

Regulation, Rebates, and RBOs

BY ERIN VANSICKLE

Studying whether to include offering a wellness program as part of a long-term care insurance policy? Your homework should include reviewing what is happening at the legislative and regulatory levels and the NAIC.

LTCI and RBO – Background

As state insurance regulators continue to analyze the health of the long-term care insurance (LTCI) market, recent discussions have focused on the inclusion of wellness programs in LTCI policies. Facing solvency concerns due to claims costs, inaccurate product pricing, low interest rates, and longer life expectancies, LTCI insurers have introduced reduced benefit options (RBOs) to prevent significant premium increases.

Long-term care insurers are also analyzing possible ways to use technology to lower the frequency and severity of LTCI claims and generally improve outcomes. Examples could include programs that aim to prevent falls; prevention and earlier diagnosis of cognitive impairment; and modifying homes to encourage aging in place.

What Happened at the NAIC?

During the NAIC Summer National Meeting, the Long-Term Care Insurance Reduced Benefit Options Subgroup discussed its LTCI wellness benefits initiative, which seeks to identify and address barriers to the increased adoption of wellness programs. As part of this effort, the subgroup released its LTCI Wellness Programs Issues paper, with comments due September 5.

The subgroup has identified barriers to increased adoption of new technology, including data privacy, such as marketing and HIPAA concerns, supplying policyholder data to wellness companies, and the purchase of policyholder-specific information. It also noted barriers that could prevent insurers from complying with the most recent version of the NAIC Model Unfair Trade Practices Act (#880). Further, the subgroup addressed ways to prevent bias-related legal issues and unfair discrimination within the life cycle of a wellness program product.

Things to Consider:

- Stakeholders should study comments on the RBO Working Group white paper that are due September 5 and the subgroup's next steps.
- State regulators will determine whether they must directly approve LTCI wellness programs or evaluate the wellness programs once they are implemented by insurers.
- Insurers with an interest in launching a wellness program should consider pre-filing meetings with regulators. As homework, insurers should be prepared to answer how innovation and technology factor into reducing future rate increases.
- Insurers should monitor the implementation of amended anti-rebating laws and consider advocacy efforts in target states/jurisdictions to encourage legislatures to adopt recent rebate exemptions to allow for LTCI wellness programs.
- Insurers should consider a full evaluation of all states' and jurisdictions' rebating laws before launching a wellness program.

Erin J. VanSickle Joins Carlton Fields' Government Law and Insurance Regulatory Teams

Carlton Fields is pleased to welcome Erin J. VanSickle as a senior government consultant focused on insurance regulatory matters. VanSickle brings more than 15 years of experience in regulated industries, public policy, public affairs, and crisis management, most recently as deputy chief of staff of the Florida Office of Insurance Regulation (OIR).

Prior to joining Carlton Fields, VanSickle oversaw communications, emergency management, and other strategic initiatives for OIR, which regulates a $154 billion industry and more than 4,400 insurance-related entities in Florida. Previously, she served as director of external affairs for Volunteer Florida and the Volunteer Florida Foundation, the state's lead agency for volunteerism and national service, where she managed public relations and legislative affairs.

VanSickle previously launched a communications firm where she advised local and statewide public affairs and legislative initiative campaigns.

NEWS & NOTES

Carlton Fields was recently recognized in *BTI Most Recommended Law Firms 2021*. The report recognizes firms that earn recommendations from outside counsel for superior client service. According to BTI, recommendations stem from delivering an excellent client experience, mobilizing quickly, being easy to engage, developing custom solutions, and incorporating deep industry insights.

Carlton Fields is pleased to announce the release of the 10th anniversary edition of the *Carlton Fields Class Action Survey: Best Practices in Reducing Cost and Managing Risk in Class Action Litigation*. The publication provides an overview of important issues and practices related to class action matters and management. The report's results were compiled from 415 interviews with general counsel, chief legal officers, and direct reports to general counsel in more than 25 industries.

The firm is a sponsor of the IRI Annual Conference on September 21–22 and 28–29, 2021. The conference brings together representatives from the entire supply chain of the insured retirement industry to explore business, political, regulatory, and technology challenges and opportunities. Shareholder **Justin Chretien** is a speaker on the session "Reg BI – Lessons Learned From Year One."

Carlton Fields is a sponsor of the ACLI Annual Conference on October 12–13, 2021. The conference covers legal, investment/financial, reinsurance, compliance, retirement security, advocacy, and legislative and regulatory issues. Shareholders **Irma Solares** and **Rae Vann** will spearhead a panel on advancing fairness at work through robust — and EEO-compliant — diversity, equity, and inclusion efforts.

The firm is pleased to participate in the ALI CLE Conference on Life Insurance Company Products on November 4–5, 2021, in Washington, D.C. Shareholder **Richard Choi** serves as the conference's co-chair, and Shareholders **Ann Black**, **Ann Furman**, and **Bill Kotapish** are speakers.

Carlton Fields worked with the ACLI to host a webinar on June 23 on the topic of implications of the confluence of fiduciary and best interest rules for annuity recommendations. Shareholder **Richard Choi** served as the moderator.

Carlton Fields was pleased to participate in the NAFA Annuity Leadership Forum on June 15. Shareholder **Stephen Kraus** spoke on the regulatory and legal issues impacting the industry.

FINRA Enforcement Senior Director Justin L. Chretien Joins Carlton Fields

Carlton Fields is pleased to announce that acclaimed securities enforcement litigator Justin L. Chretien has joined the firm's Financial Services Regulatory Practice as a shareholder in Washington, D.C. He was most recently a Financial Industry Regulatory Authority (FINRA) senior director who oversaw hundreds of cases against broker-dealers and associated persons.

Chretien has a wealth of experience handling high-stakes regulatory investigations, formal disciplinary proceedings, and litigation on behalf of FINRA and the Securities and Exchange Commission (SEC). His distinguished work has been recognized with both FINRA's Premier Achievement Award and the SEC Enforcement Division Director's Award for litigation excellence.

As a senior director in FINRA's enforcement division, Chretien directed cases involving all manner of violations of federal securities laws and the rules of FINRA and U.S. stock exchanges. Prior to his eight-year tenure in that role, Chretien was senior litigation counsel at FINRA, spearheading litigation in some of FINRA's most complex and intractable cases.

Before that, Chretien was assistant chief litigation counsel for the SEC, leading teams of attorneys, accountants, and experts in complex international securities and fraud cases as a first-chair litigator. Chretien also served as a trial attorney for the U.S. Department of Justice for more than a decade, defending the United States in complex civil litigation in federal district and circuit courts.

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