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EXPECTFOCUS®

LEGAL ISSUES AND DEVELOPMENTS FROM CARLTON FIELDS JORDEN BURT, P.A.

RAISING THE BAR

SEC ADDRESSES CONCERNS ABOUT INVESTOR CONFUSION AND REGULATORY COMPLEXITY

EXPECTFOCUS®
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New York Pushes Mutual Fund Active Share Disclosure

BY EDMUND ZAHAREWICZ

New York's Attorney General issued a report on its recent investigation of fees charged by actively managed equity mutual funds and a metric known as "Active Share." Denoted as a "percentage" from 0 to 100 percent, Active Share measures the degree of overlap between a fund's portfolio and its benchmark index. For example, an Active Share of 100 percent means that a fund and its benchmark have no holdings in common, while an Active Share of 0 percent means that the fund and its benchmark have proportionately identical holdings. Active Share is only one measure of how much "active management" is being done by the fund's manager.

The Attorney General analyzed fee and Active Share data for more than 2,000 funds to understand whether funds' fees reflect their ability to outperform their benchmarks. The Attorney General surveyed 14 major mutual fund firms "to determine whether and how firms use the Active Share metric, and whether and how firms disclose the Active Share metric to retail and institutional investors." The report's "key findings" include:

- On average, actively managed funds cost investors 4.5 times more than passively managed funds.
- Active Share varies widely for high fee, actively managed equity funds.
- "[I]nvestors cannot necessarily assume that a high fee means that a fund will have a high level of active management."
- Retail investors often do not have access to Active Share information.

Following the investigation, the surveyed firms that were not already doing so agreed to post Active Share information for each of their actively managed equity funds (400 in all) quarterly on their websites. Moreover, the report calls on all actively managed equity mutual funds, presumably including those dedicated to supporting variable insurance products, to make Active Share information readily accessible to all investors.

Although the report characterizes Active Share as a "valuable piece of information" that will allow investors "to assess whether the fees they are paying are acceptable in light of a particular fund's overlap with its benchmark," retail investors may not readily understand the inferences that can properly be drawn from this metric. For example, the report counsels that, because a fund's Active Share may change over time, investors should evaluate Active Share across multiple time periods, suggesting that a fund's Active Share at any given time may not be particularly relevant. The report goes on to note that commentators disagree about whether Active Share is linked to potential fund performance and that "Active Share may be more or less relevant depending on the type of mutual fund in question."

Unfortunately, the report does not address the potential for investor misunderstanding and, further, offers no guidance regarding what disclosures, if any, should accompany Active Share information that is made available to retail investors. One might also question the wisdom of the Attorney General's efforts to, in effect, "regulate by investigation" in an area that is already subject to comprehensive SEC and FINRA regulation and oversight.

In addition, there is a risk that regulators or private litigants may use a fund's published Active Share information to assert that the fund was less actively managed than it purported to be in other disclosures or that its advisory fee was excessive. In theory, such charges could be made as to any purportedly active fund with a portfolio that significantly overlaps its benchmark. The Attorney General's report will surely hearten, if not embolden, the proponents of such claims.

Thus, notwithstanding the Attorney General's call for readily accessible Active Share information, fund firms should proceed with caution and consider what, if any, explanatory material should accompany any such disclosure. Also, fund boards that do not already do so may wish to weigh the potential relevance of Active Share information when deciding whether to approve fund investment advisory contracts. ■

FINRA Proposes to Ease Regulation of Outside Business Activities

BY ANN FURMAN

FINRA has proposed a major paradigm shift for regulating outside business activities (OBAs) and private securities transactions (PSTs) of broker-dealer personnel. Under FINRA's proposal, a single new rule (Rule 3290) would replace current Rules 3270 (OBAs) and 3280 (PSTs) and would require registered persons to provide their member firms with prior written notice for all investment-related or other business activities outside the scope of their relationship with the member.

Work for Affiliates Excluded

Importantly for insurance-affiliated broker-dealers, work performed on behalf of a FINRA member firm's affiliates, such as an affiliated insurance company or agency, would be excluded from the rule, unless it is "broker-dealer" activity: *i.e.*, activity that would, but for the registered person's association with the member firm, require registration as a broker-dealer. (See Insurance Activity Examples, below.)

Non-broker-dealer work performed on behalf of an affiliated investment adviser (IA), affiliated bank, or relating to a registered person's personal investments, also would be excluded.

Approval of Investment-Related Activities

With respect to investment-related activities (but not other OBAs), a registered person would be required to receive prior written approval from the member before participating in the activity. The definition of "investment-related" is the same as that currently used in Form U4: "pertaining to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with a broker-dealer, issuer, investment company, investment adviser, futures sponsor, bank, or savings association)."

Upon receiving notice of an investment-related activity, the member firm would be obligated to perform a reasonable risk assessment of the activity and determine whether to approve, approve with conditions or limitations, or disapprove the registered person's participation in the activity. Non-investment-related activities no longer would require a member firm to conduct a risk assessment.

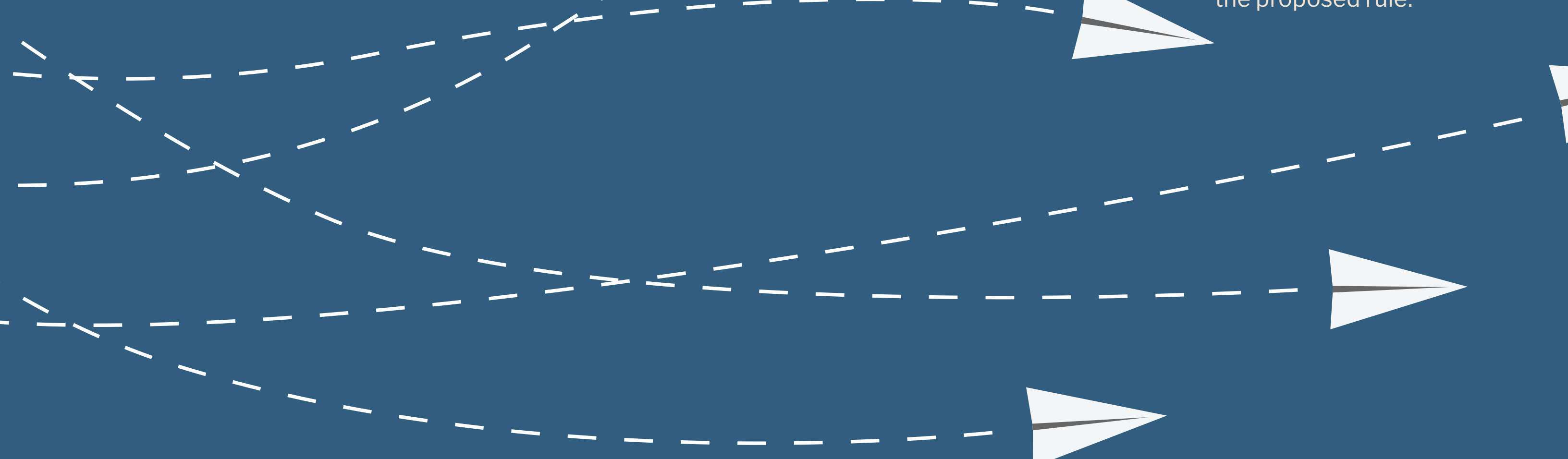
Supervision

The new rule would require supervision by member firms in two situations. First, if the activity is approved subject to conditions or limitations, the firm would have to supervise compliance therewith.

Second, supervision is required for broker-dealer activity. FINRA explained: "if the person can only legally engage in the . . . activity because the person is associated with a member, the member approving that activity must treat it as its own."

PSTs

The term "private securities transaction" is not part of the proposed rule.



However, OBAs that involve selling securities away from the broker-dealer would be subject to the same analysis and requirements as other investment-related activities. This means that, unlike current Rule 3280, proposed Rule 3290 would not apply to PSTs (as currently understood) of a member firm's associated person that is not also a registered person of the firm.

Insurance Activity Examples

By way of example, although the term "investment-related" would be defined to mean, among other things, "pertaining to . . . insurance," a registered person's activity on behalf of an affiliated life insurance company or agency would be excluded from the rule unless that activity is broker-dealer activity. Therefore:

- A registered person whose member firm is not affiliated with an insurance company or agency would be required to provide notice to, and obtain approval from, his/her member firm prior to engaging in insurance activity on behalf of that company/agency.
- A registered person whose member firm is affiliated with the insurance company/agency would not be required to give notice or obtain approval of such insurance activity unless it constitutes broker-dealer activity.
- In both cases, a member firm would be required to (a) supervise and maintain records concerning any such insurance activity that constitutes broker-dealer activity, (b) supervise compliance with any limitations or conditions that the firm imposes on any approval of any of its registered persons' insurance activities, and (c) maintain other records demonstrating compliance with the new rule.

FINRA received approximately 52 comment letters on the proposal, most favoring the new rule, some suggesting clarifications, and a small number questioning the rule's exclusion of PSTs of associated persons that are not registered persons. After evaluating the comments and making any changes, FINRA would send the proposed rule to the SEC for consideration and approval following a notice and comment period.

FINRA Moves Toward SEC Anti-Churning Proposal

BY TOM LAUERMAN

On April 18, the SEC voted to propose major rule changes to reconcile and clarify the standards of conduct that apply to broker-dealers and investment advisers. See "SEC Regulation Best Interest: Charting a Course for Securities and Annuity Sales, Avoiding Collision and Potential Regulatory and Litigation Issues" on page 8. Among other things, the SEC's proposal would require that a registered broker-dealer have a reasonable basis for believing that any "series" of securities transactions it recommends is not excessive, even if each transaction in that series, viewed individually, is in the customer's best interest.

The SEC's proposing release specifically recognizes that this requirement — which addresses a practice commonly known as "churning" of customer accounts — omits a key element necessary to establish a churning violation under federal securities law anti-fraud requirements or under the current "Quantitative Suitability" obligation under FINRA's Rule 2111. Specifically, under these provisions, a churning violation arises only if the broker-dealer has actual or de facto control over the customer's account, a limitation that the SEC did not include in its proposal.

On April 20, however, FINRA proposed to amend its Quantitative Suitability obligation so that — like the SEC's anti-churning proposal issued two days earlier — it would no longer be limited to cases in which the broker-dealer has actual or de facto control over the customer's account. FINRA stated that it had reconsidered this limitation in light of the SEC's proposal and FINRA's experience. In particular, FINRA's notice proposing this amendment explained that:

- Disputes can arise as to whether a broker-dealer has actual or de facto control over an account;
- Unscrupulous broker-dealers can use the current limitation as a shield against FINRA sanctions; and
- It is fair and appropriate for FINRA to hold broker-dealers accountable for their recommendations, even if another party decides whether to implement those recommendations.

It can be expected that FINRA will continue to adjust other current positions in response to the SEC's ongoing consideration of the standards of conduct applicable to broker-dealers and investment advisers. For example, FINRA's notice stated that it will consider the potential impact of the SEC's proposal for broker-dealer recommendations, if adopted, on FINRA's suitability rule more generally.

Expect Slower SEC Processing of Investment Company Filings

BY GARY COHEN

The SEC has reported to Congress that it expects the Division of Investment Management (IM) to provide comments at a slower pace during the 2018 and 2019 fiscal years.

As detailed below, the SEC expects IM's performance to slip significantly on initial investment company registration statements, no-action letters, interpretive requests, and exemptive applications; to slip somewhat on post-effective amendments; and to slip only slightly on proxy statements.

The SEC gave no specific reason for the expected slippage in performance, or any reason to expect that insurance product-related filings will avoid the additional delays.

- *Initial registration statements*. The SEC's goal is for IM to issue initial comments within 60 days for registration statements of insurance product separate accounts and underlying mutual funds and within 30 days for other investment company registrations. From 2012 through 2017, IM met the goals as follows: 96%, 98%, 98%, 98%, 98%, and 100%. However, IM estimates that, in 2018 and 2019, it will slip to 85%.
- *Post-effective amendments*. The SEC's goal is for IM to issue initial comments within 45 days. From 2012 through 2017, IM met the goal as follows: 95%, 99%, 99%, 98%, 100% and 99%. However, IM estimates that, in 2018 and 2019, it will slip to 90%.
- *No-action letter and interpretive requests*. The SEC's goal is for IM to issue initial comments within 120 days. From 2012 through 2017, IM met the goals as follows: 96%, 98%, 98%, 98%, 98%, and 100%. However, IM estimates that, in 2018 and 2019, it will slip to 85%.
- *Exemptive applications*. The SEC's goal is for IM to issue initial comments within 120 days. From 2012 through 2017, IM met the goal as follows: 100%, 99%, 99%, 100%, 100%, and 100%. However, IM estimates that, in 2018 and 2019, it will slip to 85%.
- *Proxy statements*. The SEC's goal is for IM to issue initial comments within 10 days. From 2012 through 2017, IM met the goal as follows: 100%, 98%, 99%, 98%, 99% and 100%. IM estimates that, in 2018 and 2019, it will slip only slightly to 99%. ▪

Recalls of Loaned Securities by Insurance Dedicated Funds

BY GAIL JANKOWSKI

In March, the SEC sanctioned the investment advisers of two funds supporting variable insurance contracts for inadequate disclosure about the funds' recalls of loaned portfolio securities in advance of the securities' dividend record dates.

The SEC reasoned that this practice resulted in a conflict of interest between the variable contract holders and the advisers, because (a) recalling the loaned securities permitted the insurance company issuers of the variable contracts, which were affiliates of the advisers, to benefit from the dividends-received tax deduction with respect to dividends paid on the securities, while (b) the funds and variable contracts supported by those funds lost the benefit of securities lending income during the period when the securities were recalled. The funds' prospectuses disclosed that a fund may lend its portfolio securities, that the loans earn income for the funds, and that the loans could be terminated or recalled at any time. The prospectuses, however, omitted any mention of the funds' practice of exercising their recall rights in a manner that provided tax benefits to the insurance companies and deprived the funds and the contract holders of securities lending income.

The SEC found this omission, and similar omissions in communications from the advisers to the funds' board, violated anti-fraud provisions in the Investment Advisers Act of 1940. As a result of the investment advisers' conduct, since June 2011, the insurance companies received a tax benefit of $2,635,490, while the funds lost $2,024,355 in securities lending income. Accordingly, the SEC required the advisers to disgorge the former amount plus interest and pay a $500,000 civil penalty.

Insurance dedicated funds that have not already done so should review their securities lending procedures and disclosures in light of this enforcement proceeding. ■

SEC Regulation Best Interest: Charting a Course for Securities and Annuity Sales, Avoiding Collision and Potential Regulatory and Litigation Issues

BY JAMES JORDEN AND BEN SEESSEL

During the past two years, we have written about potential litigation arising under the Department of Labor's, first proposed, then adopted fiduciary rule (see *Expect Focus*, Vol. II, 2015). In the first of those articles, when the Rule was initially proposed, we predicted the following as to sales of index and other annuities:

> "From a litigation perspective, this change to a fiduciary status for the sales agent is substantial and in many cases will afford litigants unhappy with investment results or the ultimate characteristics of a particular form of annuity, the opportunity to second-guess the original decision applying a significant range of issues."

The fiduciary rule was then struck down by the Fifth Circuit Court of Appeals, and within a month or so of the court's opinion, the SEC proposed a new regulation governing the regulation of broker-dealers in the recommendation and sale of securities.

This article is the first of several we will write on the potential impact of these events on the recommendation and sale of securities generally, with particular emphasis on insurance company annuities. Upcoming articles will focus on the prospect of future regulatory and litigation activity coupled with a few suggestions on how to prepare for and potentially prevent those actions. To set the stage, we will review key similarities and differences between the fiduciary rule's best interest contract exemption (the "BIC") and the proposed regulation best interest (the "RBI").

Q What are the key differences between the BIC and the RBI standards?

A There several — based on the types of transactions covered and the requirements for compliance.

1. DIFFERENT TRANSACTIONS COVERED

   The Fiduciary Rule: would impose fiduciary standards on all recommendations and sales of annuities to ERISA plans or IRAs, whether or not the annuities are "securities," (characterizing such recommendations or sales as "Investment Advice") and a violation of those fiduciary standards for sales with commission products absent compliance with the BIC exemption.

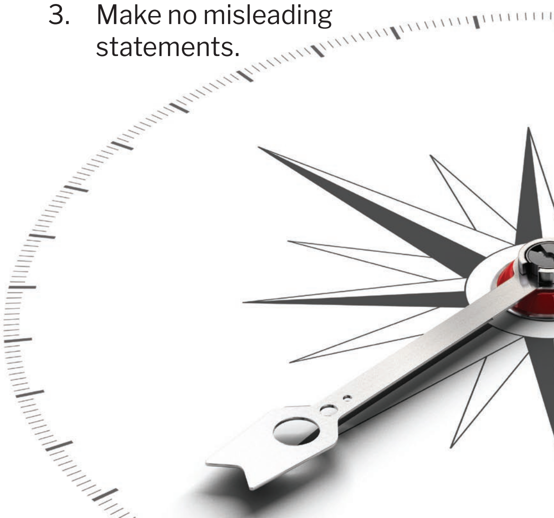
   The Regulation Best Interest: The proposed RBI imposes requirements on "recommendations" (a defined term) in connection with the sale of securities to "retail customers" (a defined term). The RBI applies to all such recommendations, regardless of the amount or type of compensation paid. It applies to both the "purchase" of a security and the "sale" of a security and specifically applies to transactions involving "rollovers" to IRA plans.

   Summary of Transaction Differences: RBI only applies to "recommendations" that involve the sale of a security — thus only variable annuities or other registered security annuities are subject to the RBI requirements.[i] The fiduciary rule applied to all forms of advice to ERISA plans and IRAs involving the purchase or sale of annuities, mutual funds, and virtually all other forms of investments. Compliance with the BIC was required to render advice or engage in such transactions involving commission sales, regardless of whether the investment advice involved the purchase or sale of a "security." Also, of course, the two standards would apply to different customers — ERISA plans and IRAs for the fiduciary rule, and all retail customers for the RBI. These general conclusions are subject to possible limitations, described more fully below.

2. DIFFERENT STANDARDS FOR WHAT CONSTITUTES 'BEST INTEREST' UNDER THE BIC AND THE RBI

   The BIC Standards: The BIC exemption requires entering into a contract with pension and IRA customers that acknowledges the "fiduciary" status of the broker or agent rendering the "investment advice" and establishes a series of best interest requirements for the advice and sale, including the impartial conduct standards that form a part of the BIC. These standards are:

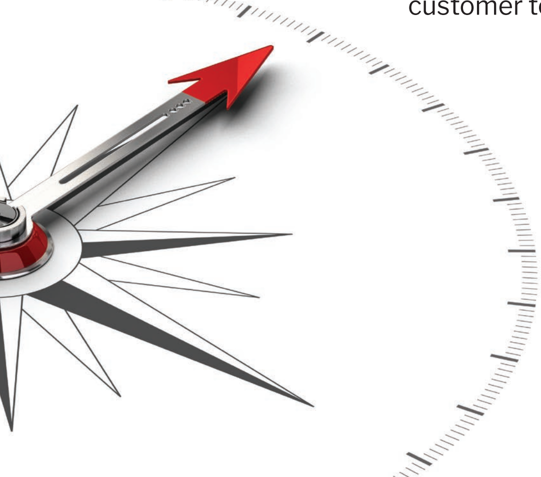
   1. Act in the "Best Interest" of the customer — defined as acting with prudence and loyalty.
   2. Charge only reasonable compensation.
   3. Make no misleading statements.



The RBI Standard: The RBI will require broker-dealers "to act in the best interest of the retail customer at the time a recommendation is made without placing the financial or other interest of the broker-dealer or natural person who is an associated person making the recommendation ahead of the interest of the retail customer."[ii] It will effectively replace the current broker-dealer "suitability" standard.[iii] The RBI standard will be met if four component obligations are satisfied:

1. The Disclosure Obligation requires brokers to disclose the "scope and terms of the relationship" and all "material conflicts of interest." The SEC release contains an example of a disclosure format — a client relationship summary (CRS) setting forth the capacity, fees and charges, and type and scope of services, as well as the nature of any conflicts of interest.
2. The Care Obligation requires broker-dealers to exercise reasonable diligence, care, skill, and prudence to:

a) Understand the potential risks and rewards of a recommendation and have reasonable basis to believe it is in the best interest of at least some of their retail customers
b) Have reasonable basis to believe the recommendation is in the best interest of the particular retail customer to whom the recommendation is being made, and
c) Have reasonable basis to believe that, if the broker-dealer is making a series of recommended transactions, that such recommendations, even if in the best interest in isolation, are not excessive and are in the best interest when viewed in total.



3. The Conflict of Interest Obligation contains two related requirements as follows:

a) Establish and enforce policies to identify, disclose, or eliminate all material conflicts of interest associated with each recommendation covered by RBI
b) Establish and enforce policies to identify and disclose and mitigate, or eliminate, material conflicts of interest that arise from financial incentives associated with all recommendations covered by RBI.

Material conflicts of interest arising from financial incentives cannot be disclosed alone, but must be disclosed and mitigated, or eliminated. The SEC has requested comment, however, on whether disclosure alone would be sufficient to address certain "material conflicts arising from financial incentives."

Summary of Requirement Differences

The fiduciary rule's BIC exemption would require acknowledgement of fiduciary status coupled with the impartial conduct standards as described above. Imposing the duties of loyalty and prudence was cast by the DOL as an acknowledgement of fiduciary standards — and the duties were coupled with specific requirements of compensation and disclosure, including the obligation to make no misleading statement and receive no more than reasonable compensation. The BIC does not specifically address a duty of ongoing monitoring. Given the required acknowledgement of fiduciary status under the BIC however, such a duty would, at least arguably, likely be required under existing ERISA precedents.[iv]

Regulation Best Interest, while acknowledging a duty of prudence (see discussion later) makes clear that the SEC is not imposing a fiduciary duty under that standard and it states in several portions of the release that RBI does not anticipate or require a "continuing duty" to monitor.[v] As pointed out in the full article, those comments seem inconsistent with other references in footnotes and text in the SEC's proposal.[vi]

In addition to the difference in fiduciary status, the RBI release acknowledges the need for and expectation of compensation, including commission compensation, resulting from the recommendation and sale of all securities. It notes that the RBI does not impose the condition that a recommendation be made "without regard to the financial or other interests" of the broker and makes clear that the level or form of compensation "would not per se prohibit a broker-dealer from transactions involving a conflict of interest."[vii]

This version of the article has been shortened to discuss only the basic outline of the two 'Best Interest" proposals. The full version contains a series of Q & A's raising, and attempting to answer, specific issues on the expected application of the RBI to broker-dealer operations and sales, and can be found at https://bit.ly/2sQHzTK. ■

i. *See* Regulation Best Interest, SEC Release No. 34-83062 (April 18, 2018) (the "release") at 1.
ii. *Id.*
iii. *Id.* at 40-43 ("we are proposing to enhance existing broker-dealer conduct obligations").
iv. *See, e.g., Tibble v. Edison Int'l*, 135 S. Ct. 1823, 1828 —29 (2015) ("a fiduciary normally has a continuing duty of some kind to monitor investments and remove imprudent ones").
v. *See, e.g.,* release at 79, 81.
vi. *See, e.g., Id.* at 134, 134 n. 222.
vii. *Id.* at 53.

SEC Warns About Third-Party Destruction of Broker-Dealer Records

BY THADDEUS EWALD

The SEC staff issued an April 12 letter addressing broker-dealer contracts with third-party recordkeeping service providers under which the service provider can delete or discard records of a broker-dealer who fails to pay fees due under the recordkeeping agreement, among other scenarios.

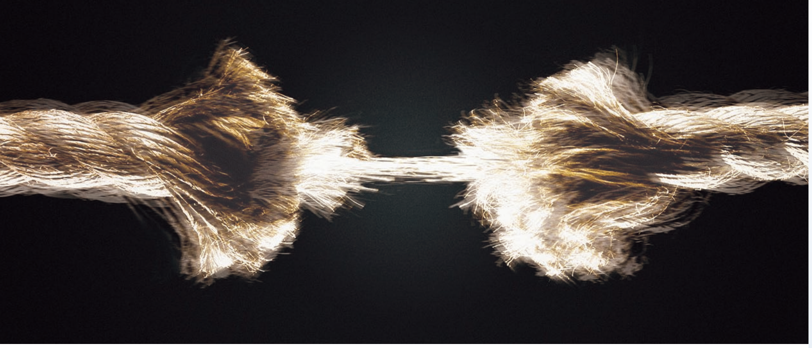
The letter, issued in response to an inquiry from the FINRA, reviews relevant requirements under the Securities Exchange Act of 1934, as well as related rules and SEC statements. These include:

- a requirement to file with the SEC a written undertaking by the third-party recordkeeper to make the broker-dealer records available to the SEC; and
- a provision to the effect that an arrangement with a third-party recordkeeper does not relieve a broker-dealer of its record preparation and maintenance obligations under SEC rules.

Such provisions are intended "to assure accessibility of broker-dealer records in situations where, for example, a service bureau refuses to surrender the records due to nonpayment of fees," according to the letter.

"[C]ontractual provisions that would permit, among other things, a service provider to delete or discard records in the event of non-payment by the broker-dealer are inconsistent with" the retention and undertaking requirements prescribed by the SEC, the letter concludes. Moreover, the letter emphasizes that deletion or disposal of records in a manner inconsistent with such requirements would not only constitute a "primary violation" by the broker-dealer, but may also subject a third-party recordkeeper to "secondary liability."

Accordingly, to avoid such violations, both broker-dealers and third-party recordkeepers have an incentive to review their practices and contractual arrangements – including those related to variable insurance products. In light of the staff's letter, it is likely FINRA and SEC exam personnel will be on the lookout for potentially problematic contractual provisions. ■



Supreme Court Set to Rule on Constitutionality of SEC's ALJs

BY NATALIE NAPIERALA, GABRIELLA PAGLIERI AND LAURA WALL

In April, the U.S. Supreme Court heard oral argument in *Lucia v. SEC* to resolve the federal circuit court split on whether the SEC's administrative law judges (ALJs) are "inferior officers" of the United States who must be appointed in accordance with the Appointments Clause of the U.S. Constitution, and not mere employees whose hiring is not required to meet constitutional standards.

The Appointments Clause requires that inferior officers be appointed by the President, the courts, or the heads of departments. Because ALJs have historically been hired by an HR division of the Commission and not the Commission itself, a finding that they are "inferior officers" could render their decisions unconstitutional, undermining the legitimacy of the SEC's in-house courts and potentially giving the myriad respondents found liable in SEC administrative proceedings a basis to challenge judgments entered against them.

In an interesting turn of events likely spurred by the new executive administration, the Solicitor General notified the Supreme Court early this year that the government would no longer defend the constitutionality of the SEC's ALJ hiring process. As a result, the Supreme Court appointed an amicus curiae, New York appellate attorney Anton Metlitsky, to defend the SEC's prior position.

Last November, the Commission attempted to resolve the issue by ratifying the hiring of its current ALJs. This maneuver arguably protects the constitutionality of current ALJs as appointed by a "head of department" pursuant to the requirements of the Appointments Clause. However, if the Supreme Court agrees that SEC ALJs were unconstitutionally appointed, the consequences of such a ruling, if any, on the viability of the decisions by previous ALJs remains unclear. We may soon learn the answer if the Supreme Court addresses this issue, along with the constitutionality question, in *Lucia v. SEC*. ■

Which Thoroughbred Will Win the Standards of Care Derby?

BY ANN BLACK, JAMIE BIGAYER AND ADRIANA PEREZ

The NAIC and the State of New York continue racing as each is revising its suitability regulation to incorporate enhanced standards of care. Only time will tell which version will gallop to victory.

While New York was fast out of the gate, and is pushing to have its version used by all states, it is not a sure bet that New York has the stamina to go the distance. The New York version is saddled with many extra bells and whistles impacting this horse's endurance. While the NAIC stumbled out of the gate after the Fifth Circuit vacated the DOL Rule, it is picking up speed.

Those placing bets should consider the differences between the two horses that will likely impact which one will win the crown:

- New York's has a broader scope by including life insurance, while the leaner NAIC stallion is focusing only on annuities.
- New York's insists on including prudence within its standard of care; several regulators were concerned about including this terminology in the NAIC version.
- New York's imposes additional requirements not included in the NAIC's version including: (1) insurer-provided comparison of fee-based and commission-based versions of products; (2) insurer prevention of incentives which would cause producers to make recommendations that are not in the best interest of the consumer; and (3) insurer procedures designed to prevent financial exploitation and abuse.

As the NAIC and New York continue to jockey for position and consider input from the crowd, ultimately, the true champion will be the horse that can deliver meaningful consumer protection in a manner the industry can implement. ■

South Carolina First State to Adopt NAIC Insurance Data Security Model Law

BY JOSEPHINE CICCHETTI

On May 3, Governor Henry McMaster signed the *South Carolina Insurance Data Security Act*, making South Carolina the first state to adopt the NAIC Insurance Data Security Model Law.

South Carolina's law, which takes effect January 1, 2019, is substantially similar to the NAIC Model, which incorporated many of the requirements of the New York Department of Financial Services Cybersecurity Requirements for Financial Services Companies Regulation. Licensees will have until July 1, 2019 to, among other things, implement an information security program and establish an incident response plan. By July 1, 2020, licensees will be expected to have a third-party service provider management system in place.

Rhode Island has also been considering the NAIC Model and other state regulators have expressed an interest in doing the same. Given that legislative sessions for this year will soon conclude, this will likely be an issue for next year's legislative calendars. While industry participants agree on the fundamental purposes of the legislation, they continue to insist that to be workable, future efforts must focus on insuring uniformity and consistency across the various jurisdictions. If that is not achieved, the insurance industry will face the cost and burden of yet another set of patchwork requirements.

Similar to the NAIC Model, the South Carolina Act ("the Act"), also sets forth "standards for data security and standards for the investigation of and notification to the Commissioner of a Cybersecurity Event applicable to Licensees…." The Act applies to all licensees, defined as individuals or non-governmental entities required to be authorized, registered, or licensed pursuant to the state's insurance laws. There are very limited exceptions to the definition. The Act also requires that all licensees develop, implement, and maintain a comprehensive written information security program (ISP).

The ISP should be based on an entity's individual risk assessment and be commensurate with the licensee's size and complexity, the nature and scope of its activities, and the sensitivity of the nonpublic information used or in the licensee's possession, custody, or control. Nonpublic Information includes information that is not publicly available and covers material business information of the licensee as well as specified personal, financial, and health information concerning a consumer or family member.

The Act requires oversight by the board of directors or an appropriate board committee, the designation of a responsible person for the ISP, and due diligence and oversight of all third-party service providers. A licensee must also monitor its program to adjust for changes in threats and technology and must establish a written incident response plan.

The Act includes specific requirements for investigation and notification to the Director of the Department of Insurance, or his designee, in the case of a cybersecurity event. A cybersecurity event is defined as an event resulting in unauthorized access to, disruption, or misuse of an information system or information stored on such system. It does not include encrypted information where the key has not been acquired, released, or used, or events where the licensee has determined that the nonpublic information has not been used or released and has been returned or destroyed. Notification to the Director by all South Carolina domiciled licensees and licensees having 250 or more insureds in South Carolina is required within 72 hours from determining a cybersecurity event has occurred. Notification to affected consumers is governed by the state's general data breach and other applicable notification laws with copies of such notices provided to the Director.

A licensee is required to certify to the Director annually (no later than February 15) that it is in compliance with the information security program requirements of the South Carolina Insurance Data Security Act § 38-99-20, as well as maintain the materials and documentation used to support the certification for five years.

The Act **exempts** from the law a licensee with fewer than 10 employees (including any independent contractors), an employee, agent, representative or designee of a licensee, who is also a licensee but is covered by the information security program of the other license, and HIPAA covered entities that certify compliance with the Act. This contrasts with the NAIC Model, which does not provide for an exemption, but includes three **exceptions** from the information security program requirements for (i) a licensee with fewer than 10 employees (including independent contractors), (ii) licensees who certify in writing that they have established and maintain an ISP that meets HIPAA requirements, and (iii) a licensee who is an employee, agent, representative, or designee of another licensee, but is covered by that licensee's ISP as long as that program complies with the information security program requirements. This deviation from the NAIC Model may require further guidance from the South Carolina Department of Insurance.

The NAIC Model is in play in other states as well (*see* sidebar).

The South Carolina Insurance Data Security Act (H.B. 4655) is available at: http://www.scstatehouse.gov/sess122_2017-2018/bills/4655.htm.

The NAIC Insurance Data Security Model Law is available at: http://www.naic.org/store/free/MDL-668.pdf. ■

States in Play! Insurance Data Security Law Status Update

Rhode Island

On June 6, Rhode Island's Senate Commerce Committee recommended that S. 2497, An Act Relating to Insurance – Insurance Data Security Act (introduced March 1, 2018) be postponed indefinitely. Instead, the Committee recommends further study of a substitute bill, S. 2497A (filed on June 6, 2018). ■

Ninth Circuit: Face Amount Controls Amount-in-Controversy Questions Where Policy's Validity is Disputed

BY SHAUNDA PATTERSON-STRACHAN

In March, the Ninth Circuit provided clarity on a key and recurring issue relevant to a district court's ability to exercise subject matter jurisdiction in actions involving the validity of life insurance policies. On review of a summary judgment grant for the insurer, the court evaluated, sua sponte, whether the California federal district court that dismissed the action had subject matter jurisdiction. The case, *Elhouty v. Lincoln Benefit Life Company*, had landed in federal court as a result of the defendant's removal. The Ninth Circuit recognized that, while the parties were completely diverse, as 28 U.S.C. § 1332(a) requires, "the contours of our amount in controversy jurisprudence are not entirely clear."

The dispute and the plaintiff's action for declaratory judgment focused on whether the plaintiff's Lincoln Benefit life insurance policy "remained in full force and had not lapsed," or had lapsed due to the plaintiff's failure to pay the requisite policy premiums, even after notice. But the court distinguished the case before it from those where the dispute centers on whether the plaintiff owed the insurer some amount of money or the insurer owed the policyholder particular policy benefits. Rather, because "this case concerns whether the policy remains in force or was instead properly terminated," the case is "one where the controversy relates to the validity of the policy" itself.

Citing decisions by multiple other Federal Courts of Appeal, the Ninth Circuit recognized "it is long-established that in declaratory judgment actions about whether an insurance policy is in effect or has been terminated, the policy's face amount is the measure of the amount in controversy." Thus, concluded the court, where Mr. Elhouty's policy had a $2 million face amount," that sum reflected the "value of the matter in controversy," and the district court's exercise of subject matter jurisdiction was proper.

Elhouty may also merit review for the court's ruling that the district court did not abuse its discretion in striking the plaintiff's expert witness, where, in addition to procedural failings (the plaintiff missed the deadline for disclosing expert reports and failed to timely respond to the defendant's motion to strike), the plaintiff failed to "show[ ] how an expert opinion could help his case." ■

Win for MassMutual in Rare Class Action Trial

BY BRENDAN GOOLEY

A California jury recently returned a verdict in favor of MassMutual following a 12-day trial in a state-court class action that claimed the insurer failed to pay dividends owed to policy owners.

Named plaintiff Christina Chavez claimed that MassMutual failed to determine whether the participating life insurance policies in the class were sufficiently profitable to trigger the requirement that owners receive a portion of MassMutual's divisible surplus (excess profits). She asserted that MassMutual never even bothered to run the calculations required to determine whether dividends should have been paid. MassMutual responded that the policies at issue never generated enough profit to trigger dividends.

A pivotal issue in the trial was a battle between the experts for the class and the insurer. According to the class' expert, MassMutual owed the plaintiffs somewhere between $500,000 and $700,000. MassMutual's experts, however, asserted that the company did not owe the class any additional dividends. MassMutual focused on discrediting the expert for the class and his methods.

Those efforts paid off. The jury concluded that the plaintiffs had failed to prove that their policies were profitable enough to trigger MassMutual's duty to pay them dividends. Interestingly, the special verdict form used by the jury suggests that it agreed with the plaintiffs' assertion that MassMutual did not even run the calculations to determine whether the class members were entitled to dividends. That did not matter, however. MassMutual persuaded the jury that it had since performed the required calculations and found that no dividends were owed. ■

COI Litigation Update

BY BROOKE PATTERSON

Life insurers that defend challenges to their exercises of discretion to adjust cost of insurance (COI) rates on universal life insurance policies continue to seek opportunities to narrow the scope of the claims through early dispositive motions. In May, an Ohio federal district court partially granted a defendant insurer's motion to dismiss, providing a recent example where an insurer had some success with this strategy. In *Farris v. U.S. Financial Life Ins. Co.*, the plaintiff, the trustee of a trust that purchased the subject policy in 2001, alleged that the insurer increased the COI to rid itself of liabilities and recoup prior losses, allegedly contrary to the permissible bases the policy articulated. In her putative class action complaint, plaintiff asserted six claims: breach of contract, breach of implied covenant of good faith and fair dealing, unjust enrichment, conversion, fraudulent misrepresentation, and fraudulent suppression.

USFL moved to dismiss all claims except the breach of contract claim, and moved to strike portions of the complaint it characterized as immaterial and impertinent to the case. The district court dismissed the unjust enrichment claim, as the dispute was governed by the contract. In so doing, the court rejected the plaintiff's contention that the claim could be maintained because of alleged evidence of fraud. The court pointed out her failure to cite controlling authority on the issue. The court also dismissed the fraud claim predicated on USFL's alleged concealment of the state of its financial solvency and alleged mismanagement, finding, *inter alia*, that alleged misrepresentations on its website and in corporate statements were too vague and ambiguous, and noting that the complaint was silent as to whether the plaintiff had even read them.

However, the court allowed other claims to proceed. The fraud claim regarding the 2015 rate increase survived as an alternative cause of action despite the court's recognition that it could not find that USFL owed a duty separate and apart from the policy. The remaining claims, for conversion and breach of the covenant of good faith and fair dealing, also survived, as the court ultimately found both were adequately pled. Finally, the court denied the motion to strike, finding that USFL did not demonstrate that the allegations — regarding a prior rate increase and alleged so-called "shadow insurance" — did not relate to the subject matter or cause significant prejudice to the defendant. ■

Unclaimed Life Insurance Benefits: The First Half of 2018 in Review

BY THADDEUS EWALD

The pace of developments in the unclaimed life insurance benefits space remained active in the first six months of 2018, with new judicial decisions and state legislative enactments making an impact.

Judicial Developments

In April, a Florida state court granted summary judgment in favor of life insurers challenging the retroactive application of amendments to the state's Disposition of Unclaimed Property Act that required insurers to perform Death Master File (DMF) searches for all policies dating back to 1992. The court accepted the insurers' argument that the retroactivity violated their constitutional due process rights notwithstanding that the amendments explicitly provided for retroactive application. Specifically, the court concluded: the amendments related to the DMF search; contacting beneficiaries after the policyholder's death and dormancy triggered new obligations and duties; and the amendments were substantive and thus could only apply prospectively. The state of Florida filed a notice of appeal in May.

This decision follows a 2014 Kentucky Court of Appeals decision, cited by the Florida court as persuasive, that likewise struck down the retroactive application of DMF search requirements. However, the Kentucky court avoided the constitutional question by basing its decision on a statutory interpretation principle that precludes retroactive application absent the legislature's express statement of retroactive intent. The Florida decision is a warning to other state legislatures considering retroactive application of DMF search requirements: even though Florida tried to bulletproof its statute following the Kentucky decision with an express statement of retroactive intent, it was still vulnerable to a constitutional challenge. The Florida and Kentucky rulings have potentially far-reaching implications for challenges against existing state DMF laws with retroactive application and for states with pending unclaimed life insurance benefits bills.

Legislative Developments

In Illinois, a law expanding the state's Unclaimed Life Insurance Benefits Act's DMF requirements took effect January 1, after the legislature overrode the governor's veto late last year. That law, in relevant part, applies its DMF search requirements retroactively to lapsed or terminated life insurance policies, annuities, contracts, or retained asset accounts in a tiered system based on whether the insurer maintains electronic searchable files and whether the insurer had entered into an agreement with the state treasurer based on an unclaimed property examination. Governor Bruce Rauner (R) vetoed the bill based partially on concerns that its retroactive application was unconstitutional.

The NCOIL Model Unclaimed Life Insurance Benefits Act (the "NCOIL Model") — which requires insurers to search in-force policies, contracts, and accounts against the DMF and make good faith efforts to locate and contact beneficiaries where potential matches are identified — continues to make headway in state legislatures but is notably silent on the retroactive application of its requirements. Nebraska's version of the NCOIL Model, which it enacted last spring, took effect January 1, with no provision prescribing retrospective (or prospective) application. Likewise, Wisconsin Governor Scott Walker (R) signed his state's form of the NCOIL Model into law on April 3, with an April 1, 2019 effective date set. The question of retrospective or prospective application was again left unanswered.

With these various enactments, 30 states now have unclaimed life insurance benefits laws based on the

NCOIL Model with several other states considering their own. Both chambers of the Hawaii legislature have passed an NCOIL Model-based bill that awaits action by Governor David Ige (D) and comparable legislation has been introduced in several other states including Massachusetts, Minnesota, Oklahoma, and South Dakota. ■

To Preempt or Not to Preempt – Courts Issue Competing SLUSA Rulings

BY LAURA WALL

During two weeks in April, two different courts — the Second Circuit and the New Jersey Superior Court — considered nearly identical allegations regarding variable products and reached diametrically opposed conclusions about the extent to which the claims were barred by the Securities Litigation Uniform Standard Act (SLUSA).

In *Shuster v. AXA Equitable Life Insurance*, a putative class action involving variable life insurance policies, the plaintiff alleged that the contracts provided that AXA was not to make any material changes to the investment strategy related to the policies without first informing appropriate regulatory agencies. Plaintiff claimed AXA breached this provision by implementing a new "volatility-management strategy" in 2009 without adequately informing the New York Department of Financial Services, and that this act affected policyholders' investment, resulting in reduced returns. The action's procedural history included AXA's removal of the case to the New Jersey federal district court and its move to dismiss the breach of contract claim as barred by SLUSA, which preempts class actions that allege misrepresentation or omission of a material fact in connection with the purchase or sale of a security. The New Jersey federal district court judge remanded the action. In state court, AXA again moved to dismiss, this time successfully.

In an April 17 ruling affirming the action's dismissal, the New Jersey Superior Court found, based on the complaint's allegations, the alleged misrepresentation did not necessarily induce the purchase of securities, but did result in a trading strategy within AXA's accounts that ultimately reduced returns to putative class members. Like the trial court, the appellate court relied on a New York federal district court case, *Zweiman v. AXA Equitable Life Insurance Company*, which challenged the same investment strategy. There, in a 2015 opinion, the court broadly construed the requirement that the deception occur "in connection" with the purchase or sale of securities, finding the element was satisfied because the alleged fraud negatively impacted the securities. The New Jersey Superior Court agreed with this logic and found that SLUSA precluded the breach of contract claim. The *Shuster* court did not, however, cite a Second Circuit ruling reversing a SLUSA-based dismissal of a suit involving a putative class of variable annuity policyholders issued the week before — despite the fact that the same alleged misconduct by the same defendant was at issue.

Specifically, in its April 10 ruling in *O'Donnell v. AXA Equitable Life Ins. Co.*, the Second Circuit considered a strikingly similar case and refused to adopt the *Zweiman* court's analysis. Rather than broadly construing SLUSA's "in connection with" element, the Second Circuit noted that the alleged misrepresentation to a regulator and the inaction of a securities holder to buy or sell were unconnected. It also found there was no reasonable inference that AXA misled the plaintiff or the market more generally in a manner that influenced the purchase or sale of securities. As a result, the Second Circuit concluded that SLUSA did not preempt the plaintiff's breach of contract claim. ■

NEWS & NOTES

Carlton Fields released its seventh annual Class Action Survey, providing an overview of important issues and practices related to class action matters and management. The publication covers historical trends and information related to emerging issues gathered from interviews with general counsel or legal decision makers at 385 companies. The survey is available at www.ClassActionSurvey.com.

Above the Law named **Carlton Fields** to its inaugural Top Law Firm Privacy Practice Index. The firm was one of only 25 in the nation named to the index, described by *Above the Law* as "an attempt to capture the most active and relevant law firms in this complex and rapidly evolving practice area."

Carlton Fields earned top rankings for 11 of the firm's practices and 31 attorneys in the 2018 *Chambers USA Guide to America's Leading Business Lawyers*. The firm's insurance practice group ranked number one in the nation for the 14th consecutive year.

The *BTI Brand Elite 2018: Client Perceptions of the Best-Branded Law Firms* listed **Carlton Fields** as one of the best-branded law firms among general counsel and legal decision makers. Specifically, corporate counsel ranked the firm in the top 15 percent of all firms for using technology in new ways to add client value.

Shareholders **Ann Black** and **Richard Choi** spoke at the Association of Life Insurance Counsel Annual Meeting in Half Moon Bay, CA, on May 6-8 on a panel titled, "Securities Investigation and Enforcement Actions and Insurance Product Sales to Investment Advisor Clients."

Several members of the Carlton Fields life insurance industry group participated in the Insured Retirement Institute's ACTION18 Conference in Washington, D.C., on May 9-10. Shareholders **Josephine Cicchetti, Gary Cohen, and Wally Pflepsen** served on the conference planning committee. Panels included "The Hottest Litigation Topics – A Year in Review," co-chaired by **Wally Pflepsen** and with panelists **Michael Valerio** and **Dawn Williams;** "How We Learned to Stop Worrying and Love the Best Interest Standard," moderated by **Jim Jorden;** "Cybersecurity Update," moderated by **Josephine Cicchetti;** Q&A with Deputy Director Paul Cellupica from the SEC Division of Investment Management, moderated by **Richard Choi;** "Protecting Older Investors," moderated by **Ann Furman;** and "The Evolving Variable Market," moderated by **Chip Lunde**.

The firm's Chief Operating Officer, **Anastasia "Annie" Hiotis**, was elected Chair of the Board of Equality Florida Institute Inc., a local arm of the nation's largest civil rights organization for the lesbian, gay, bisexual, and transgender (LGBTQ) community.

Carlton Fields welcomes the following attorneys to the firm: Of Counsel **Marguerita Brunson Sims** (health care, Tampa), and Associates **Scott Richards** (national trial practice, Orlando) and **Nathaniel Foell** (national trial practice, Tampa).

Carlton Fields is pleased to announce that **C. Peter Hitson** has joined the firm as the Director of Legal Project and Practice Management. A noted project management executive in the legal industry, he brings deep experience in Lean and Six Sigma disciplines that will help continue to drive Carlton Fields' innovative legal project management (LPM) objectives.

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